S. HRG. 101-269

TELEMARKETING FRAUD

HEARING

BEFORE THE

SUBCOMMITTEE ON THE CONSUMER

OF THE

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION

UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

ON

PENNY STOCK FRAUD

AUGUST 22, 1989

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TELEMARKETING FRAUD

TUESDAY, AUGUST 22, 1989

U.S. SENATE,
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION,
SUBCOMMITTEE ON THE CONSUMER,
Las Vegas, NV.

The subcommittee met, pursuant to notice, at 2 p.m., in the boardroom of the Las Vegas Convention and Visitors Authority, Hon. Richard Bryan presiding.

Staff members assigned to this hearing: Kevin Curtin, staff counsel and Sherman Joyce, minority staff counsel.

OPENING STATEMENT BY SENATOR BRYAN

Senator BRYAN. I'd like to convene the Consumer Subcommittee of the United States Senate Commerce Committee to order and to indicate to some of the people that join us here today for this hearing.

I'd like to preface my comments by thanking a number of you here who have joined us today who are not going to be appearing as witnesses and testifying but invite each of you to the extent that you wish to share your experiencies with the committee, the record of this proceeding is going to be held open.

We would welcome any written comments that you might care to send to us and at the conclusion of the hearing we'll make available an address where you can send any such comments that you might want to add to this record so that we can have that information as well.

Appearing with me today from Washington on my far right is Ralph Everett. Mr. Everett is the chief counsel and staff director of the full Senate Commerce Committee and appearing here on behalf of Senator Fritz Hollings from South Carolina.

Immediately to my right is Kevin Curtin who serves as senior counsel and my staff counsel for the consumer subcommittee.

On my left is Sherman Joyce who serves as Republican staff counsel for the Republican members of the U.S. Senate Consumer Subcommittee, and to my immediate left is Andy Vermilye who is my legislative assistant and our staff liaison for the Senate Banking Committee.

Joining us this afternoon is a distinguished panel. Let me introduce them all first if I may. Frankie Sue Del Papa, the Secretary of State, in which the Securities Division is situated and joining Frankie Sue is one of her deputies, Sherwood Cook. We're delighted to have him with us today.

Larry Struve, who serves as director of the Department of Commerce and accompanying Mr. Struve is Shari Compton who heads up the Consumers Affairs Division and is located in southern Nevada.

We're delighted to have Joe Goldstein with us, and Joe is the head of the Task Force on Penny Stock Fraud, Securities and Exchange Commission from Washington, D.C., and joining Mr. Goldstein is Mr. Bob Davenport who is the director of the Denver office of the SEC.

Today's hearing marks a first in a series of hearings devoted to the problem of telemarketing fraud. It is a problem which has cost the American consumer over $1 billion each year. And I dare say that the presence of some, indeed probably many, of you here today would attest to the level and magnitude of that fraud.

High pressure telephone sales campaigns have become a major source of consumer fraud. As the chairman of the consumer subcommittee I believe that we must alert all consumers everywhere of the inherent risks in telephone solicitations by unscrupulous companies. Later this year I will be introducing legislation to combat this ever-growing problem at the national level.

As many of you know in 1987 the State Legislature enacted legislation at the state level vesting that jurisdiction with the Secretary of State. That legislation was reenacted by the recently adjourned 1989 legislative session here in our own state.

Today's hearing will focus on the problems associated with telemarketing fraud in the penny stock market. There are increasing indications that penny stock fraud and abuse are reaching epidemic proportions in America and that Nevada citizens have become a prime target of such efforts.

Penny stocks are low priced, usually trading under $3 per share and are not traded on any of the major exchanges such as the New York or the American Stock Exchanges. Therefore, it is extremely difficult for the small investor to obtain information on penny stock companies, and thus, the stocks are ripe for manipulation. Some people would claim that most penny stocks are not even as valuable as their name implies.

While my focus is on the far-reaching problems associated with the penny stock market, I should also note that the market does in some instances serve a legitimate and important purpose for the capital funding of small entrepreneurial enterprises in the State of Nevada and elsewhere. Without this market, some small entrepreneurs might not be able to get the capital and the financing necessary to develop and market their products so it's important to emphasize that there is a legitimate use of penny stocks that is worth protecting.

Our focus this morning as well as in other subsequent hearings will be to weed out the criminal elements. Most importantly I am concerned that individuals, often those who can least afford the financial loss, are being suckered into turning over hard-earned money by high-pressure salespersons who have little knowledge of the financial market but a lot of knowledge about closing of a sale.

Often, a salesperson's only on-the-job training consists of a script to be read over a telephone, and an order to start dialing. They

work the long distance telephone lines from New Jersey to Florida to Colorado and as you all know here in Nevada as well.

We will hear today about one such firm, Power Securities, that was located in our state. Power was founded in 1987 for what appears to be the sole purpose of quickly enriching its owners through a concerted scheme to defraud thousands of unwitting investors in penny stocks.

All of these findings rather dramatically illustrate the need for decisive and efficient action to protect Nevadans as well as Americans across the country. I'd like personally to acknowledge and commend the actions that have been taken by Nevada Secretary of State Frankie Sue Del Papa, the Secretary of State's office and Secretary of Commerce Larry Struve and his department insofar as steps have been taken by the Nevada legislature to regulate telephone solicitations. I would intend to craft a national legislative model. The bill's in the final works. It's been done here in the State of Nevada, and my bill will reach out to more carefully control the interstate aspects of telemarketing fraud.

I would also acknowledge and commend the United States Securities and Exchange Commission for the step that they took last week to curb penny stock fraud and the regulation that was promulgated and look forward to working with the SEC in developing legislative solutions.

Our first witness this afternoon will be the Secretary of State. It's my pleasure to call upon an old friend and a friend to many of you. Frankie Sue grew up here in southern Nevada, and now lives in northern Nevada where she serves as our Secretary of State. Frankie Sue Del Papa, welcome.

STATEMENT OF FRANKIE SUE DEL PAPA, SECRETARY OF STATE FOR THE STATE OF NEVADA

Ms. DEL PAPA. Mr. Chairman, for the record, I am Frankie Sue Del Papa, Secretary of State for the State of Nevada. With me today from my office is Sherwood Cook, Deputy Secretary of State for the Securities Division.

Let me thank you for the opportunity to participate today.

Senator BRYAN. Can you pull that microphone just a little closer?

Ms. DEL PAPA. And also let me acknowledge and applaud your continuing interest in this area of the law.

As you know, when I took office two and a half years ago the situation in Nevada relative to the Securities Division was that we had an outdated law and three employees statewide to try to enforce it.

Nevada was getting the reputation as being one of the so-called "boiler room" capitals of our country. Not only were our citizens victims, but a significant number of scams were unfortunately originating from our state.

With your strong support as Governor, the 1987 Nevada Legislature passed what is in essence the Revised Uniform Securities Act of 1985, and our Securities Division staff went from three people to fourteen, supported by a full-time Deputy Attorney General.

This new law is the state of the art, including tough antifraud provisions. The effective date for Nevada's new law was January 1,

1988. Since that time, enforcement activity has climbed dramatically. Not only has the number of formal enforcement actions substantially increased, but also our cooperative efforts with other enforcement agencies, federal and state, both within and without the state, have sent a message that Nevada is not what she used to be relative to securities scams.

Let me now address two areas of our enforcement activity that are most relevant to this field hearing on telemarketing fraud. Those being dirt pile schemes and penny stocks.

According to the North America Securities Administrators Association investors in America lose $10 billion per year or about $1 million every hour to con artists working phones to sell overpriced penny stocks, piles of dirt, fake art prints and a variety of other worthless investments.

Investors across the United States lose approximately $250 million a year on dirt pile scams alone. These scams involve the sale of what an investor is told is valuable ore containing gold or silver which is to be extracted in the future. Needless to say, investors seldom, if ever, receive any gold or silver. For the most part, what the investors purchase is a very expensive pile of dirt containing only traces of metal.

To date, 52 dirt pile scams have been identified across the country. The Nevada Securities Division has taken formal action against 12 dirt pile companies and has 8 additional active investigations.

As an aside, let me say that our office has received tremendous cooperation from the Nevada Mining Association and also we recently hosted a national conference on mining scams which received national press coverage including being mentioned in a Sylvia Porter column and in the June 5th issue of Fortune magazine.

Moving on, in addition to dirt pile scams Nevada has had its share of penny stock frauds. According to the North American Securities Administrators Association penny stock fraud is the No. 1 investment fraud problem in the country today. In a report issued last week the Secretary of State of the State of Georgia, Max Cleland, stated that, quote, individuals who could least afford financial loss are being suckered into turning over their hard-earned money by high-pressure and minimally educated salespersons who had little knowledge of the financial markets but a lot of knowledge about closing a sale, end quote.

Again, for the most part penny stock fraud is a telephonically executed fraud committed on unsuspecting, unsophisticated investors who purchase overpriced or worthless stock.

Penny stock market problems were once considered a Rocky Mountain aberration confined to a few states like Utah, Colorado, and Washington. However, the problem has spread to the point of being considered a national epidemic. The Securities and Exchange Commission recently identified 6 areas where they considered penny stock fraud to be prevalent: South Florida, New Jersey, Los Angeles, Denver, Utah and Nevada.

Nevada must acknowledge that fraud in its penny stock market does exist. And again, the fraudulent activities originating here affect not only state residents, but through the use of telephones

and the expansion of operations, local firms have victimized citizens throughout the United States. This is exemplified by a class action suit which was filed in February of this year against a Las Vegas based penny stock firm. The plaintiffs in that action are seeking $345 million in damages for investors across the country who suffered losses at the hands of the firm.

Besides the obvious fraud aspects, problems in the penny stock market include inexperienced salesmen, a lack of information about the companies whose stock is being traded, and unsophisticated investors who rely on unreasonable representations made by penny stock salespersons.

In the past the Securities and Exchange Commission has been a bit slow in responding to the problems in the penny market. However, I would like to personally commend the SEC, and in particular Chairman David Ruder, for the recent actions taken which will have a significant deterrent affect on penny stock fraud. The actions include the establishment of a penny stock fraud task force, increased enforcement actions and, most recently, as you mentioned, the adoption of Rule 15c2-6 which will make it more difficult for penny stock swindlers who victimize investors through cold call sales.

The Securities Division in my office has also been active in combating fraud in the penny market. We have adopted strong regulations which inhibit the creation of fraudulent investment vehicles like blank check blind pools. Also, in the last year and a half, the Division has taken formal enforcement action against 8 penny stock firms and has 10 pending investigations.

The penny market does have legitimate aspects and does include, of course, reputable companies. However, the legitimacy of the penny market is becoming less and less apparent and most reputable security specialists are beginning to ignore penny stocks.

Let me conclude by saying our office has and will continue to dedicate a significant portion of its time to public education. We believe that part of our mission is to continually alert the public to be on guard, particularly to telemarketing, and particularly from people they do not know.

Today's hearing is important because it helps focus additional attention in this area. We appreciate your continuing interest and we pledge our continuing cooperation.

Senator BRYAN. Thank you very much. I think we'll take testimony from all the panelists and then ask some questions. Next we'll hear from Mr. Larry Struve, formerly the Chief Deputy Attorney General now with the Department of Commerce. Mr. Struve.

STATEMENT OF LARRY STRUVE, DIRECTOR, DEPARTMENT OF COMMERCE, STATE OF NEVADA

Mr. STRUVE. Thank you, Senator Bryan. It's a pleasure to appear before you today. In fact, as I look around the room I think the last time you and I were in here together we were prosecuting the Beatty nuclear dump site.

Senator BRYAN. Although you want to emphasize I was not sitting across the table but next to you, Larry.

Mr. STRUVE. Indeed. That is a memory I will never forget. In my presentation today, Senator, I want to acknowledge, before I forget, the fine work of Shari Compton, the Nevada Commissioner of Consumer Affairs who is with me today, her Deputy Attorney General Phil Burns who is in the audience and her senior investigator Ron Shutt and Miss Sue Vaughn who is going to be heading the new telemarketing licensing program that I will be mentioning in my presentation.

We tried to establish in the Department of Commerce a teamwork approach in dealing with the telemarketing problems that we've encountered in the State of Nevada for the past few years. I don't know how many on your staff or the subcommittee know about the organization of the Nevada Department of Commerce but there are nine divisions plus the director that comprise our department.

The Consumer Affairs Division is only one of those nine divisions. And that is the division that has had the prime responsibility for the past several years in dealing with the complaints from consumers who feel they have been defrauded from the telemarketing industry and it is the Consumer Affairs Division that has had to deal with those problems.

We, of course, are very grateful that the 1987 legislature passed the statute that Secretary of State Del Papa was just referring to because prior to that time it was up to the Consumer Affairs Division to handle those complaints and all of the others that arose out of the telemarketing industry based here in the State of Nevada.

And when you realize the volume of work that comes into that division and the scope of the fraud that goes way beyond penny stocks but into many other activities including the sale of goods, services and even other investment opportunities, I think you can get a picture of what a burden this is on state and local authorities.

For instance, in 1988 we had a total of 6,784 written complaints filed in the Nevada Consumer Affairs Division. That's in all 26 categories for which we will investigate to see if there's been a violation of law. We received 62,322 phone calls. We held 55 administrative hearings and we negotiated 31 assurances of discontinuance.

And I think this is going to be a theme that you hear in many of your hearings from those who are out in the field dealing with fraud problems arising in the marketplace, a need to prioritize the work and never having as much staff or resources as you would like to address on the problem.

Senator, I have handed out to your staff and to you a statement that is dated today which I will incorporate into the record because that really contains the history of what we've done in the Nevada Consumer Affairs Division over the past five years. I'm not going to read that letter. I don't think that is necessary, but I would like to highlight a couple of main points that are outlined in that letter.

Senator BRYAN. We'll make that statement, Larry, a part of our record.

Mr. STRUVE. All right. First of all, the problems I've outlined in this letter to you, Senator, indicate that telemarketing fraud and its relationship to penny stocks is really only a part of the very general problem of fraud in the telemarketing industry, at least as we've had to deal with it in the Nevada Consumer Affairs Division.

And one of the things that we've noted in Nevada is that there has been a growth of what are called boiler rooms which unfortunately have generated a number of the complaints that came into our division over the past five years.

I've attempted in this letter to describe for the subcommittee what are the unique characteristics of a boiler room and how the opportunity for fraud can develop in the course of marketing whether its penny stocks, hair tonic, piles of dirt or any other product or service.

One of the key elements of a boiler room operation is the offer of a prize or a premium. It's the sizzle that gets the attention of the prospective customer on the other end of the line. Once that customer is attracted by the sizzle and is enticed into placing an order, the next significant characteristic of a boiler room is that they arrange for immediate payment, usually through a charge to a credit card or in some cases having Federal Express bring the cash to the boiler room operation. This is done, Senator, before the customer really sees the product or service or investment opportunity that they are purchasing.

The final characteristic is set forth on page 4 of my letter under subparagraph f. which describes the dilemma that faces a consumer if they find after they have placed the order and they receive the product, service, business opportunity or the prize or premium that was offered which is usually 30 to 60 days after the order is placed that that item was not as represented or they just find they really don't want to go through with the transaction.

And at that point the consumer is faced with the dilemma of how to go about cancelling the sale and that's where your regulatory agencies come in and that's where the thousands of complaints that I'll mention in a moment have been generated from those frustrated and angry consumers who either want their money back or who claim that they have been deceived or defrauded in the course of the sales presentation and they've actually lost their money because of the nature of the industry to get quick payment once the order is placed.

As you will note, on page 2 there is a history of the boiler room industry in the State of Nevada and in that I wanted to point out the effect that this growth has had on our Consumer Affairs Division. In 1984, 15 percent of all the complaints we received into our Consumer Affairs Division dealt with what is called the telemarketing fraud problem. However, that represented a 20 percent commitment of our resources in the division to handle those 15 percent complaints.

By 1985, that had grown to 17 percent with a 23 percent commitment of Division resources. From 1986 to 1988 there was a dramatic increase in the number of complaints that came from this industry or which were identified in this category and over half of all complaints came from the telemarketing industry and they consumed 60 percent of our division's staff and resources.

In tab A. of the letter I've given to you, Senator, the actual statistics are set forth, which are based upon written complaints filed with our division during the period January 1986 through December 1988.

As these complaints came in, there was general interest generated throughout the State of Nevada and particularly in the news media that something had to be done about these kinds of operations that were generating this volume of complaints, and under tab B. I've given the subcommittee a sampling of some of those news reports and editorials which asked that something be done to get a handle on these activities.

In 1989, the Nevada legislature was presented with a bill by Assemblyman Matt Callister here in Las Vegas in which there were many cosponsors in the Nevada legislature. When that bill was heard before the Assembly Commerce Committee, Shari Compton and I testified in its support, and I've attached under tab C. my letter outlining for that Committee what our experience had been between 1987 and 1988 in dealing with telemarketing fraud problems in Nevada.

That letter states we received 6,000 complaints in the area of telemarketing fraud and the average loss claimed by a complainant during that period was $500. If you will calculate the amount of the average loss times the number of complaints, you will see that just in those two years from those who contacted our division the claimed loss was in excess of $3 million. If that was the situation in Nevada I'm sure the Committee can appreciate it would be much greater than that if you take in the country as a whole.

Since we started keeping records of this problem, we have received a total of 15,300 written complaints and over 66,000 telephone inquiries from consumers who have various problems in this industry. My staff in the Consumer Affairs Division has calculated that the total losses to consumers during this period from 1984 up to the present would be a total of $8.1 million based upon information contained in written complaints filed with our division.

The boiler room industry in Nevada has gone through a cyclical period. In 1988 we had 400 telemarketing firms in Nevada hiring approximately 20,000 persons. I'm informed that currently that is down to about 60 firms with 5,000 salespersons.

As I indicated, the 1989 Nevada legislature felt that a different approach had to be taken to this problem other than relying on the commencement of civil or criminal actions to try to punish those who had already caused harm to consumers who had complained. What A.B. 142, Chapter 615, 1989 Statutes of Nevada, Senator, does is it establishes a licensing scheme in the State of Nevada for firms that wish to do business in the telemarketing industry.

As my letter points out, there are five basic purposes to the statute. I've indicated the first one. It requires that anyone who wants to engage in telemarketing in this state must be licensed by the Consumer Affairs Division and any salesperson who is going to contact consumers has to be licensed.

Secondly, it creates sales communications and the function of this board is to improve the regulations of the commissioner, to implement the statute, to adopt its owns rules and procedure and for those who were either denied a license or were subject to a revocation or suspension of their license because they violate statutes or regulations relating to this industry. They are the appeals board and would make the final decision.

The statute sets forth a number of requirements for licensure. They include posting a bond and financial security. They include background checks and require the approval of the scripts that will be used over the telephone to induce the consumer to purchase the product or service.

Fourth, the statute prescribes rules that must be followed in making certain sales pitches. With the thought being if they violate those rules of procedure and it can be established to the satisfaction of the commissioner that is the basis for a revocation action and lastly there are civil and criminal penalties provided under this law which will become a new chapter in the Nevada Revised Statutes.

Now, Senator, as significant as this legislation is, and I think it represents landmark legislation in the State of Nevada, it still doesn't really address the kind of problem that I think this committee is focusing on, and that is the interstate nature of telemarketing fraud, and on page 9 of the letter that I've handed out to you I have made some suggestions——

Senator BRYAN. This is your cover letter, Larry?

Mr. STRUVE. Yes. This is the letter dated August 22nd, and starting on the bottom of page 9 and on page 10 of that letter I've made some suggestions that the subcommittee may want to consider in enhancing efforts like those here in the State of Nevada to get a handle on the telemarketing fraud problem.

The first suggestion I have made is that there should be the encouragement on the federal level of joint federal-state task forces who can initiate enforcement actions in those states or localities where telemarketing fraud appears to be concentrated. I don't believe that you're going to be able to find that you can solve all this problem by a single agency based in Washington, D.C. This is a very fluid industry. It moves around a lot and those firms that don't wish to comply with Nevada law that are currently based here will think about leaving and possibly opening operations in another state.

We found through the cooperation of the FBI, the Secret Service, the postal service, district attorneys in this state, the Attorney General, Better Business Bureaus and many others that we were able to bring a focus to the problems we had in this state and we were successful both in bringing enforcement actions to close down the shops that were generating the most complaints and to devise a statute that was acceptable to the 1989 Nevada legislature.

The suggestion here is that the committee may want to consider how you can devise a mechanism that would facilitate the creation of these specialized joint task forces anywhere in the country where the telemarketing problems seem to be concentrating and to have flexibility so you can move your resources quickly into the areas where the problems seem to be going.

Secondly, we have suggested that you consider a mandate or an authorization for the Federal Trade Commission to establish a national plan or strategy to deal with unregulated business enterprises that engage in large scale telemarketing fraud that harm large numbers of consumers. The lack of a national strategy under the current circumstances results in a hodgepodge approach to this problem and I'm sure as you will hear as you go around the coun-

try some states are much better prepared than others to deal with this problem when they surface.

I think a national plan or a national strategy promoted and publicized by an agency like the Federal Trade Commission would help bring all states and localities up to speed as to what can be done in protecting themselves against a large scale telemarketing problem in their community.

Thirdly, we would recommend that the Committee seek legislation that would generate resources, financial resources to help the state, local and federal agencies that are going to be involved in handling the myriad of complaints that can arise out of this type of problem. We also recognize the problem of the federal deficit. However, one idea the Committee might consider would be whether or not authorization could be given to federal and state authorities to obtain resources through the seizure of goods or services that are illegally sold and that those resources can then be committed to funding the necessary staff and other resources to carry on an anti-fraud effort.

Fourth, we think that the Committee should consider the expansion of the authority of the Federal Trade Commission to take enforcement action against deceptive and unfair practices in the unregulated telemarketing industry and that you should consider whether or not this authority could be shared with state or local law enforcement officials possibly through prior approval of the FTC itself.

Our experience at the state level has been that there are obviously higher priorities in federal agencies than there may be for us here in the State of Nevada but if there was concurrent jurisdiction in which the local or the State

Attorney General or local law enforcement officials could with prior approval of the FTC commence actions in the federal forum to enforce federal anti-fraud statutes, you would not only be enhancing the law enforcement efforts in this area, but you would avoid the box that we are all in now where there probably will be inefficient resources at the federal level for the FTC to do the entire job itself.

Going along with that you should consider strict penalties. I'm sure as you will hear from other testimony there is tremendous volume and tremendous money involved in this scam so that penalties for violation of any statute you consider should be commensurate with the amount of money that is generated.

Lastly, I think it would be worthwhile for the Committee to consider whether or not a single federal agency or official should be designated as the coordinator for fighting telemarketing fraud, one source where state and local governments can go to get a consistent answer on what is the best approach to the particular problem they're facing there in their particular local area.

We believe these are only suggestions at this point but would be a good starting point to help compliment and implement what states like Nevada are trying to do in dealing with the problems localized here in our state. We've always recognized the limitations of our jurisdiction and authority and we are concerned what will happen if we're really successful in the implementation of 142 but then find we are receiving complaints from our citizens because

they're receiving calls from those who have now located elsewhere and are not subject to the kind of laws that we have.

I'd like to thank you very much for the opportunity to make this statement. I hope it's been helpful. We wish the Committee well.

[The statement follows:]

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August 22, 1989

Consumer Subcommittee of the Senate
Committee on Commerce, Science and Transportation
c/o Senator Richard H. Bryan
Consumer Subcommittee Chairman
Field Hearing
Las Vegas Convention and Visitors Authority
Board Room
Las Vegas, Nevada

Re: Overview of Nevada Department of Commerce Experience with Telemarketing Fraud

Dear Senator Bryan and Members of the Consumer Subcommittee:

Thank you for the opportunity to address the Senate Consumer Subcommittee and to provide an overview of the experience in the Nevada Department of Commerce in dealing with the thousands of consumer complaints filed with our Consumer Affairs Division over the past few years involving telemarketing fraud.

Even though the focus of your field hearing in Las Vegas is the "penny stock fraud problem" in Nevada, the volume and nature of the complaints filed with the Nevada Consumer Affairs Division over the past three years would indicate that problems of fraud and deception have extended into many other areas of the telemarketing industry.

As a result, my remarks deal with the more general problems of telemarketing fraud that have surfaced in the State of Nevada over the past three years. I shall also update you with an overview of the 1989 Nevada Legislature's response to these general problems, culminating in the passage of A.B. 142, Chapter

615, 1989 Statutes of Nevada. Finally, I would like to offer some suggestions that the Subcommittee might consider by which the federal government could assist state and local government agencies in implementing programs that will deal more effectively with the types of general telemarketing fraud that we have experienced in Nevada.

A. Growth of "boiler rooms" and telemarketing fraud in Nevada, 1984-1989.

Over the past several years, law enforcement and regulatory agencies in Nevada have become increasingly concerned with activities of "boiler rooms" located within the State of Nevada. These operations have utilized cleverly designed telemarketing sales pitches, which have generated increasing numbers of consumer complaints filed with a variety of state and local agencies, based on allegations of fraud and deception.

1. What are the unique characteristics of a "boiler room?"

According to the staff of the Consumer Affairs Division in the Nevada Department of Commerce, a "boiler room" is a business enterprise in which the primary activity involves telephone sales solicitations made through the use of one or more salespersons, who deal exclusively with prospective customers on the telephone in an attempt to sell a product, service, or some sort of business or investment opportunity. Unfortunately, the prearranged telephone sales pitches used by these enterprises often mislead or deceive a prospective customer, resulting in the sale of a product, service or business/investment opportunity that does not conform to the representations made over the telephone.

Typically, boiler room operations have the following characteristics in their methods of operation:

a. A telephone inquiry is made on behalf of the boiler room owner to a business or individual. If the inquiry is to a business, the call is directed to the owner. Usually, the caller conveys some personal knowledge about the business or owner, which knowledge has been gleaned from mailing lists purchased by the boiler room staff from sellers of such lists. Alternatively, boiler room operators may have acquired some personal knowledge of the business or individual through the use of direct mail techniques, in which flyers (mailers) are sent to the prospective customer containing a representation that the recipient has won a prize or gift or other sort of premium that can only be claimed by calling the telephone number of the boiler room.

b. Once a personal contact is made over the telephone, the salesperson employed by the "boiler room" invariably informs the business owner or prospective customer that he or she has won a gift, prize or award of considerable value. A sales presentation or "pitch" is then made to the consumer, in which the product, service, or business/investment opportunity that the boiler room operator is intending to sell is interlaced with continual references to the gift, prize, or award that was initially offered. Usually, the gift, prize, award or other premium has been embellished by the telemarketer to such an extent that the consumer becomes convinced that in order to obtain such a gift, prize, award or premium, he or she must purchase the offered product, service or business/investment opportunity, even though the consumer is not particularly interested in what is actually being purchased.

c. After a prospective customer is persuaded to take advantage of the offer of a gift, prize, award or premium by the boiler room salesperson, an order for the purchase of the product, service or business/investment opportunity that is the condition precedent to obtaining the prize is placed over the telephone by the consumer. Examples of the types of products sold through this technique in Nevada include items such as pens, pencils, key chains, ball caps, and a host of other products that will presumably be printed with the logo, name, address and telephone number of the business or individual placing the order. This activity is sometimes known as "advertising specialty sales." However, in addition to the sales of items that can be used in advertising, the technique has been successfully used to persuade consumers to order a host of other items, including vitamins, land, gas and oil leases, gold mine leases, silver mine leases, precious metals, foreign money exchanges, and hair or skin tonics.

d. Central to the aforementioned sales technique is the "pitch" from the boiler room salesperson that the consumer/customer is getting a bargain by purchasing the product, service, or business/investment opportunity from the boiler room. However, based on complaints filed with the Nevada Consumer Affairs Division, the price charged for the various types of products and services sold over the telephone have turned out not to be a bargain at all. For instance prices have ranged from $25.00 for pens to $100,000 or more for gas or oil leases, which have turned out to be actually worth considerably less than these amounts.

e. Once an order is confirmed by a salesperson working for a boiler room, payment is made either by federal express courier or through the use of a credit card authorized by the customer/consumer, which is immediately turned into the bank so

that the customer/consumer cannot cancel the order without a very long and involved process that may or may not include a refund or charge back for a dissatisfied consumer who did not get what was represented over the telephone.

f. Central to the success of a boiler room operation is the receipt of money immediately after the consumer/customer is persuaded to place an order over the telephone. Usually, the product, service, or business/investment opportunity is not delivered to the customer until 30 to 60 days after the order has been placed and payment made. When the consumer/customer finds out that the product, service, or business/investment opportunity is not as advertised or represented in the course of the telephone conversation with the salesperson, he/she is usually unable to readily contact the "boiler room" operation to obtain a refund or charge back on the consumer's credit card. In addition, some boiler rooms have either misrepresented the gift, prize, award or premium to be received by the consumer upon placement of an order or have failed to send the item as promised, and the consumer must then seek redress through law enforcement and regulatory agencies or through private litigation, which can be a long, involved and costly process.

2. Recent history of "boiler room" operations in Nevada. 1984-1989.

Business enterprises in Nevada operating as "boiler rooms" first became an enforcement/regulatory issue in 1984. Since July of 1984, the Consumer Affairs Division of the Nevada Department of Commerce has maintained statistical data on 26 reporting categories used in keeping track of consumer complaints. Included is a category for complaints arising out of telephone sales solicitations used by "boiler rooms." In 1984, 15% of all reported written complaints filed with the Consumer Affairs Division involved complaints against boiler rooms. Due to the nature of these complaints, 20% of the Consumer Affairs Division's manpower and resources were devoted to dealing with these types of complaints.

By 1985, the number of complaints filed with the Consumer Affairs Division against boiler rooms had increased to 17% of all complaints, and 23% of the Division's manpower and resources were devoted to handling these matters.

In 1986, the increase in the number of complaints and the commitment of Consumer Affairs Division resources dealing with boiler room consumer problems increased dramatically. Attached to this statement behind Tab A are three charts labeled Exhibits 1, 2, and 3, listing the number of complaints filed against boiler rooms (telemarketing firms) from December 1986 through

July 1989. As these charts indicate, over 50% of all complaints filed with the Consumer Affairs Division in the Department of Commerce during this period dealt with the telemarketing (boiler room) industry, and the Nevada Commissioner of Consumer Affairs has estimated that 60% of her manpower and resources were devoted to handling these complaints during this 3-1/2 year period.

Concurrent with these developments, the media in Nevada ran a series of articles and editorials, urging strong action to be taken against the fraudulent practices of telemarketing firms based in Nevada. Copies of some of these selected articles and editorials are attached to this statement behind Tab B.

Also attached to this statement behind Tab C is a copy of a letter dated February 27, 1989 to the Nevada Assembly Commerce Committee, outlining the experience of the Consumer Affairs Division in dealing with telemarketing fraud complaints for the period 1987-1989. This letter points out that, according to the Consumer Affairs Division's statistics, 6,001 complaints were filed with the Division for the two calendar years 1987 and 1988 dealing with alleged telemarketing fraud. Most of these complaints dealt with offers of prizes or valuable gifts that were never received or sales of grossly inferior products that did not match the representations of the sales pitches over the telephone. These types of complaints represented nearly 55% of all complaints received in the Consumer Affairs Division statewide in 1988.

As of mid-August, 1989, the staff of the Nevada Consumer Affairs Division reported that, since records have been maintained, over 15,300 written complaints and more than 66,000 telephone inquiries have been received from consumers/customers, complaining about fraud and deception resulting from telemarketing (boiler room) operations.

3. Losses to Consumers from Telemarketing Fraud.

As indicated on the attached letter of February 27, 1989 to the Assembly Commerce Committee of the Nevada Legislature (Tab C), it has been estimated by the staff of the Consumer Affairs Division, based on a random sample of written complaints received during the period 1987-1989, that the average amount of loss sustained by each consumer complainant has been nearly $500.

Overall, the Consumer Affairs Division has estimated that the total loss claimed by consumers who contacted the Division in 1984, 1985, and 1986 approximated $2.5 million. For the period 1987, 1988 and 1989, an additional loss of $5.6 million has been calculated. These estimates are based upon the written complaints filed with the Division.

Accordingly, in Nevada alone, the scope of potential losses sustained by consumers from fraudulent activities in the boiler room industry have been in the millions of dollars. Obviously, this figure would be considerably higher for the nation as a whole.

4. Size of Boiler Room Industry in Nevada.

Based upon a survey completed by the Consumer Affairs Division in cooperation with various local licensing agencies throughout the State of Nevada, it has been estimated that over 400 boiler room operations were actively engaged in sales solicitations in Nevada in 1988, employing approximately 20,000 sales personnel. Currently, it is estimated that 60 boiler room companies are actively engaged in telemarketing operations in the State of Nevada, employing 5,000 persons. The average number of employees working for each company varies with the number of telephone lines that the boiler room operation purchases. An average boiler room, according to Consumer Affairs Division statistics, employs 25 persons in a typical telephone sales room, though one of the largest boiler rooms in Nevada has been known to employ 900 persons and the smallest only 1 person.

B. Nevada's Response to the Telemarketing Fraud Problems of Boiler Rooms.

Because of the growth in the number of complaints and the drain on the Consumer Affairs Division's resources, an effort was initiated in the 1987 Nevada Legislature to strictly regulate the activities of boiler room operations. The legislation did not pass during that session.

Subsequent to the 1987 Nevada legislative session, the Commissioner of Consumer Affairs formulated a task force comprised of law enforcement, regulatory, and consumer protection agencies to address the problems arising out of the boiler room/telemarketing industry and to develop a proposal that would be acceptable to the Nevada Legislature. Included on the task force were representatives of the Federal Bureau of Investigation, United States Secret Service, business license agencies in southern Nevada, the Las Vegas Metropolitan Police Department, the United States Postal Inspection Service, the Reno Police Department, representatives of the district attorneys in Washoe and Clark counties, representatives from the private sector, including the Better Business Bureau of both northern and southern Nevada, Chambers of Commerce throughout the state, representatives of Master Card and Visa, and some banks doing business in the State of Nevada.

Concurrent with the rise of consumer complaints in 1988, the task force coordinated enforcement efforts, and a number of law suits were filed by the Nevada Attorney General on behalf of the Commissioner of Consumer Affairs as well as by local district attorneys in Nevada, based on allegations of fraud and deception. This activity appeared to have had a dramatic impact on the volume of complaints received. As can be seen in Exhibit no. 2 (Tab A) a dramatic drop in the number of complaints occurred in July, 1988, after four major enforcement actions were filed in May and June of 1988. However, each enforcement action required the commitment of a large share of the resources of the law enforcement agency.

In addition, the task force developed a legislative proposal, which was endorsed by Governor Bob Miller and legislative leaders and was ultimately enacted as A.B. 142, Chapter 615, 1989 Statutes of Nevada, a copy of which is attached to this statement (Tab D) and will become fully effective on October 1, 1989.

C. Summary of Major Provisions of A.B. 142, Chapter 615, 1989 Statutes of Nevada.

A.B. 142, introduced by Assemblyman Matt Callister of Las Vegas, accomplished five essential purposes:

1. First, the statute requires certain telemarketing firms and their salespersons to be licensed and regulated by the Consumer Affairs Division of the Nevada Department of Commerce, effective October 1, 1989. Many firms and individuals have been exempted from this new licensing requirement, including the following:

a. Those which are subject to other licensing requirements or regulations of state or federal law;

b. Non-profit corporations that do not confer personal benefits on individuals;

c. Large, national catalogue merchandisers;

d. Those businesses that do not intend to complete sales transactions by telephone;

e. Those that are involved in sales of livestock or agricultural products less than $100 in value;

f. Those involving the sales of telephone answering services and the solicitation of contracts for the repair and maintenance of goods or products previously purchased from the

person making the solicitation;

g. Those soliciting previous customers if no premium is offered, no unregistered investment opportunity is involved, and the business is not regularly engaged in telephone sales.

It was the hope of the legislature that the primary focus of the legislation would be on boiler room operations, which were the cause of virtually all the consumer complaints described in the preceding section.

2. Second, A.B. 142 creates a new five member State Board of Telephone Sales Communications, which has the following authority:

(1) To approve regulations proposed by the Commissioner of Consumer Affairs establishing licensing requirements and standards of conduct for telemarketing licensees.

(2) To adopt regulations for the conduct of the Board's business; and

(3) To review and decide appeals by any person aggrieved by the imposition of a civil penalty, denial of an application for a license, or the revocation or suspension of a license by the Commissioner.

3. Third, any firm or individual seeking a license to engage in a telemarketing enterprise must provide detailed information on the backgrounds of the people to be involved in the operation, the script or other material to be used in making sales pitches, a bond or other acceptable financial security in the amount of $50,000 conditioned on compliance with A.B. 142, and a detailed description of any gift, premium, bonus or prize to be offered to consumers and the conditions connected therewith in the course of a sales pitch on behalf of the telemarketing firm.

4. Fourth, the statute prescribes certain rules that must be followed in the course of a licensee's telemarketing operations, including identification for each consumer of the firm and person making the sales pitch, information on the value and conditions applicable to any premium, gift or prize offered a consumer, and notification to each consumer of his or her right to obtain a refund or replacement of any goods or services purchased that are defective or not as represented or not received as promised.

5. Fifth, the statute provides for civil penalties of up to $5,000 for a single violation and up to $25,000 for multiple

violations if a telemarketing firm discloses the name or address of any person purchasing goods and services from the telemarketing firm to anyone not authorized to receive this information. In addition, felony penalties are provided for violations of the licensing requirements, and misdemeanor penalties are provided for salespersons who solicit on behalf of an unlicensed telemarketing firms.

Currently, the Consumer Affairs Division is in the process of promulgating regulations to implement this statute, and they will be submitted to the new State Board of Telephone Sales Communications for approval. It will take time to assess the ultimate impact of this legislation on the boiler room industry in Nevada. However, it is hoped that those boiler rooms which can operate without fraud or deception of its prospective customers will remain and those which cannot will cease doing business in this State.

D. Areas in which Federal Legislation could Assist State and Local Governments in Dealing with Telemarketing Fraud.

As noted above, the efforts of the Nevada Department of Commerce and State Legislature have focused on the licensing and regulation of boiler rooms doing business from a location in Nevada. A.B. 142 is truly landmark legislation for the State of Nevada, and Governor Miller, the 1989 Nevada Legislature, and all the participants of the task force who worked on this problem are to be commended for their hard work on the ultimate result achieved.

However, because of the interstate nature of the telemarketing industry, it will be very difficult for the State of Nevada to protect its consumers from fraudulent operations that are based outside of the State. Furthermore, if Nevada is successful in enforcing its new licensing legislation, there is the possibility that major boiler room operations that do not desire to comply with Nevada's law may relocate to other states that do not have the same type of strict consumer protection statutes.

Accordingly, the Nevada Department of Commerce is hopeful that your Subcommittee will consider recommending federal legislation that would enhance and complement but not preempt the efforts of state and local governments to control and reduce fraud and deception in the telemarketing industry. Some ideas worth considering are the following:

(1) Authorize or encourage joint federal-state task forces to initiate enforcement actions in those states or localities where telemarketing fraud appears to be concentrated. In Nevada,

officials from federal and local law enforcement agencies worked well together on the joint task force established by the Consumer Affairs Division to deal with problems arising out of boiler rooms headquartered in this State. In addition, there was cooperation in the initiation of actions to enjoin fraudulent operations.

(2) Mandate or authorize the Federal Trade Commission to establish a national plan or strategy to deal with unregulated business enterprises that engage in large scale telemarketing fraud that harms large numbers of consumers. Without a national plan or strategy, state and local governments will always be faced with a shortage of manpower and financial resources to deal with large scale telemarketing operations that affect thousands of consumers in several different states and localities.

(3) Consider legislation that would generate resources to assist state and local governments in the development of programs designed to deal with local problems of consumer fraud resulting from the telemarketing industry. In this connection, consideration might be given to authorizing federal or state authorities to seize property and money obtained through fraudulent or deceptive activities by unregulated boiler rooms or telemarketing firms, which resources could then be committed to future enforcement efforts.

(4) Expand the authority of the Federal Trade Commission to take enforcement action against deceptive and unfair trade practices resulting from the unregulated operations of boiler rooms or other telemarketing firms, which authority could be exercised concurrently or, upon prior approval of the F.T.C., independently by state or local enforcement officials.

(5) Provide strict criminal and civil penalties for violations of federal legislation prohibiting deceptive and unfair practices in the context of interstate telemarketing.

(6) Consider enactment of legislation by which the federal government and state and local law enforcement authorities can share information that will enable a speedy prosecution for violators of federal and state fraud laws applicable to the telemarketing industry.

(7) Designate a single federal agency or official as the primary authority to coordinate enforcement and regulatory programs dealing with fraud arising from the interstate operations of the telemarketing industry.

Thank you again for the opportunity to address your Subcommittee. We hope the above comments are helpful in your deliberations, and we wish you well in your efforts to resolve the problems that have unfortunately surfaced within this growing segment of America's business community.

Sincerely,

Larry D. Struve

LARRY D. STRUVE
Director

LDS:dl
Atts. 1/

1/ The attachments were not reproducible and are in the Committee files.

Senator BRYAN. Thank you very much, Mr. Struve. Next we'll hear from Mr. Goldstein. We thank him once again for his interest in this issue. I believe you were in Oregon yesterday for similar types of field hearings by the House and we're delighted to have you here in Nevada with us today.

STATEMENT OF JOSEPH GOLDSTEIN, ASSOCIATE DIRECTOR, DIVISION OF ENFORCEMENT, SECURITIES AND EXCHANGE COMMISSION

Mr. GOLDSTEIN. That's correct, and thank you for inviting us. Mr. Chairman, for the record I am Joseph Goldstein, associate director of the Division of Enforcement of the Securities and Exchange Commission and Chairman, SEC penny stock task force. To my right is Bob Davenport the head of the SEC Denver regional office. Bob and his office have been involved in prosecuting penny stock fraud for many years and have brought many of the Commission's most significant cases in this area. I have presented to your staff a copy of my written testimony. We'd appreciate it being put in the record.

Senator BRYAN. It will be made a part of the record, Mr. Goldstein.

Mr. GOLDSTEIN. Thank you. At this time I'll just summarize my written comments. The Securities and Exchange Commission appreciates this opportunity to testify about the Commission's efforts to protect investors from penny stock fraud. Losses to investors who are caught in fraudulent schemes in this market amount to far more than pennies. When penny stock schemes collapse, innocent public investors are left holding worthless stocks for which they often have paid many thousands of dollars. Profits to broker dealers and their salespersons, however, can be very large.

For example, according to the U.S. attorney for the district of New Jersey, F.D. Roberts, penny stockbrokers allegedly realized gross trading profits of at least $67 million over a 3-year period.

Salespersons in some firms can reportedly make $10,000 to $20,000 per month after a year's experience. Top salespersons at some penny stock firms have earned between $20,000 to $50,000 per month. The abuses in the penny stock market have been reflected in the increased number of complaints received by the Commission from individual investors.

In the first half of fiscal 1989 that figure rose to 2,462 complaints compared to 1,510 complaints for all of fiscal 1988 and this figure really is not truly reflective of the volume of problems in this area because many people do not write to the SEC. They write to state regulators. They write to the self-regulator, the National Association of Security Dealers or they don't write at all and it is a large and growing problem.

In response to these concerns in October 1988 Chairman David Ruder of the SEC announced the formation of a penny stock traffic force. During the past ten months, the task force has sought to marshal the Commission's resources in seeking efficient and effective solutions to penny stock fraud and manipulation.

The task force identified four goals for the Commission in its effort to combat penny stock fraud, increased cooperation and co-

ordination with other federal, state and local regulators and prosecutors, stepped up enforcement activities, including criminal referrals when appropriate, targeted regulatory solutions and investor education.

The Commission has made significant progress in each of these areas. The goal of developing stronger cooperation and coordination with federal and state regulators and prosecutors and whether the NASD has been of vital enforcement for effective enforcement. We share the belief that one agency in Washington with regional offices throughout the country is not sufficient to deal with this problem. We need to work with all states and self-regulators to deal with this problem effectively.

The task force in trying to enhance this kind of cooperative attitude has sponsored 9 regional meetings around the country for state and federal security regulators and prosecutors. The purpose of the meetings has been to share information and discuss strategies for dealing with penny stock fraud. These meetings have been very helpful in forging a stronger network of communication and cooperation among regulators and prosecutors.

An example of this cooperative effort is a Florida Penny Stock Task Force which includes the SEC's Miami branch office, the State of Florida, the NASD and federal law authorities. This now serves as a model for ongoing state and federal cooperation.

The Commission has also conducted training sessions for staff from other federal and state agencies about securities fraud to increase the number of civil and criminal cases brought by other authorities in the penny stock fraud area.

The task force is also working to achieve its goal of increasing Commission enforcement actions in criminal referrals in this area. In fiscal 1988 the Commission initiated 25 enforcement actions involving penny stocks. This—so far in fiscal 1989 the Commission has brought 46 actions. There is a substantial increase over the prior year. A number of the Commission actions this year involve new companies and broker dealers.

In November this past year, actually in 1988, the Chicago regional office brought an action against Stoneridge Securities which was located here in Las Vegas and several of its principals. The Commission alleged that Stoneridge manipulated the penny stocks of several Nevada companies by using figurehead officers and directors, selling the company stock at artificially inflated prices, using nominee accounts, false press releases and forged documents. The fraud also included a no net sale policy at Stoneridge, that is salespersons could not accept customers unless there were other customers too.

Further, this broker made no suitability determination for any of its customers. This caused severe losses to investors who could not afford them. For example, the complaint alleges that one of Stoneridge's registered representatives solicited a 76-year-old retired construction worker to buy one of his stocks with his life savings. The customer resided in subsidized housing and his primary source of income was his Social Security check.

This is the kind of victim who just cannot possibly afford to lose money on these kinds of schemes. In related proceedings Nevada has suspended the licenses of the firm's principals and the Commis-

sion has brought an action against Arnold Kimmes and other defendants who are alleged to be involved in Stoneridge Securities and other stock manipulations. Arnold Kimmes has also pled to a two count indictment with assistance from the SEC and the IRS.

Too often the Commission's experience is that people responsible for organizing, financing and executing stock manipulations in penny stocks are not deterred by the civil remedies that are currently available to the Commission. These civil remedies are viewed as part of the cost of doing business; therefore, to determine more effectively penny stock fraud the Commission is actively seeking to enlist the help of criminal prosecutors. This is why it's so important that there be criminal actions brought against penny stock manipulators such as those brought by the U.S. Attorney against Arnold Kimmes which I just mentioned.

A very significant development in prosecution is the recent undercover operation by the FBI and U.S. Attorney's office for Utah which was conducted with the assistance of Bob Davenport's regional office and the SEC branch office in Salt Lake City. That operation led to criminal actions against ten defendants including an accountant, promotor, transfer agent, a broker and sellers of shell companies.

State security regulators also play a critical role in combating penny stock fraud. The North America Securities Administrators Association has undertaken new initiatives to focus public attention on this problem and to coordinate the states' efforts in this area. States are able to civilly and criminally prosecute penny stock fraud manipulators quickly and effectively.

One recent significant example is a series of enforcement actions that various states have initiated against Power Securities Corporation which was headquartered here in Las Vegas and which you mentioned in your opening. At least at that time Power Securities was the largest and fastest growing penny stockbroker in the country. Actions were brought by Nevada, Florida, Montana and New York against Power Securities. Following the action brought by New York, Power Securities terminated all retail sales activity nationwide.

The NASD has also taken enforcement initiatives in this area by instituting its own enforcement agency, working with U.S. Attorneys' offices, the Commission and various state regulators. In the area of regulatory initiatives the task force is reviewing the Commission's regulatory structure for the purpose of proposing regulations targeting penny stock fraud. A broad range of ideas have been discussed by the task force as well as with representatives from state and federal agencies.

As a result of these discussions, as was previously noted, the Commission recently adopted rule 15c2-6 which has been called the penny stock rule. This rule will take effect on January 1, 1990, and is carefully structured to protect investors from the high pressure unsolicited telephone sales tactics used in penny stock manipulations.

Other regulatory initiatives have been proposed and are being considered. The task force also is focused on increasing investor awareness on how to recognize and avoid penny stock schemes. The task force has written and distributed to investors bulletins on

penny stock fraud, the first entitled "Beware of Penny Stock Fraud!" Provides basic information about penny stocks, describes warning signs of penny stock fraud and recommends steps investors should consider before investing in penny stocks.

The second entitled "Penny Stock Telephone Fraud" gives examples of the types of tactics sometimes used in high-pressure cell phone sales schemes. It also recommends steps investors should take to reduce their chances of being victimized by penny stock fraud.

Copies of both these brochures have been included in the exhibits that are a part of my testimony.[1] Particularly hearings like this one where the public hears from investors and from regulators are extremely valuable in helping to inform other members of the investor public about the dangers of penny stock fraud.

In conclusion, the Commission and penny stock task force are committed to continuing their efforts in protecting the public from penny stock fraud. Over the last few months the Committee has made progress in enforcement, regulatory initiatives, providing investor education and fostering cooperation with our law enforcement authorities. The Commission wants to thank the subcommittee for this opportunity to report on its activities in this area. Thank you.

[The statement follows:]

[1] The attachments were not reproducible.

STATEMENT OF JOSEPH I. GOLDSTEIN, ASSOCIATE DIRECTOR, DIVISION OF ENFORCEMENT, SECURITIES AND EXCHANGE COMMISSION 1/

I. Introduction

Mr. Chairman and Members of the Subcommittee:

The Securities and Exchange Commission appreciates this opportunity to testify about the Commission's efforts to protect investors from penny stock fraud.

"Penny stocks" is a term used to refer to low-priced securities traded over-the-counter. The majority of these securities are quoted in the "pink sheets" published daily by the National Quotation Bureau. Many penny stocks represent legitimate investment opportunities. However, other penny stocks are utilized in fraudulent schemes which involve "shell" companies with no operating history, few employees, few assets, and no legitimate prospects for business success.

Penny stocks often are traded in a market subject to domination and control by a single market maker. Penny stock fraud occurs when penny stocks are utilized in schemes designed to manipulate their prices upwards, allowing brokers to charge their customers undisclosed excessive mark-ups and insiders to sell at inflated prices, and when promoters direct the proceeds of the initial sale of penny stocks to themselves. Innocent investors are the primary victims of these fraudulent schemes.

Certain patterns are characteristic of penny stock fraud. Most penny stock frauds involve the following factors:

- control of the market by one or only a few broker-dealers that often have contacts with the promoter of the issuer;

1/ The attachments to this statement were nor reproducible.

- increasing prices through pre-arranged matched purchases and sales of penny stocks;
- false or misleading press releases about the issuers' prospects;
- high pressure "boiler-room" sales practices, including unfounded price projections by inexperienced salespersons under the direction of professional salespersons who specialize in penny stock solicitations;
- grossly inflated price spreads and sales prices that include undisclosed excessive mark-ups by the broker-dealers involved; and
- the dumping of securities at inflated prices by the promoters or brokers who then move on to the next manipulation as stock prices collapse.

There are large amounts of money to be made in the penny stock market. Penny stocks initially may be sold to investors for pennies per share, but eventually may have market prices substantially higher when sold or resold to the investing public. According to a survey done by the Commission's Denver Regional Office, during the period 1982 to 1984, secondary market trading of just 500 Denver area penny stock offerings aggregated over 15 billion dollars.

Losses to individual investors who are caught in fraudulent schemes in this market also amount to more than "pennies." Penny stock issues that become the subject of a market manipulation

often are sold to investors at artificially inflated prices to investors. When such schemes collapse, innocent public investors are left holding worthless stocks for which they often have paid many thousands of dollars.

The profits to broker-dealers and their salespersons also can be enormous. For example, over approximately a one month period, two penny stock brokers monitored by one of the Commission's offices traded shares of two companies with a combined net worth of about one million dollars. During this month, the brokers' profits in transactions involving these companies amounted to $3.5 million, more than three times the net worth of the two companies. In another case, a branch office of a penny stock firm made more than a one million dollar profit in a single day through its activities in the penny stock market. Salespersons in some firms can reportedly make $5,000 a month after six months and $10,000 to $20,000 per month after a year's sales experience. Top salespersons at some penny stock firms have earned from $20,000 to $50,000 per month.

The abuses in the penny stock market have been reflected in the increased number of complaints received by the Commission from individual investors. In fiscal 1988, the Commission received 1,510 complaints involving penny stock firms (12.5% of all complaints received by the Commission). In the first half of fiscal 1989, that figure rose to 2,462 complaints (34% of all complaints). Yet, the number of firms primarily engaged in the

penny stock business represents less than 5% of the registered broker-dealers in this country doing business with the public.

On October 21, 1988, Commission Chairman David S. Ruder announced the formation of a Penny Stock Task Force ("Task Force"), of which I am chairman. The Task Force was created in response to the serious violations of the federal securities laws taking place in the over-the-counter market for low-priced securities. Representatives from each of the Commission's operating divisions are included on the Task Force, as well as representatives from the Commission's nine regional offices. During the last ten months, the Task Force has sought to understand the scope of the apparent problems in this market and to marshal the Commission's resources in seeking efficient and effective solutions to penny stock fraud and manipulation.

The Task Force identified four goals for the Commission in its efforts to combat penny stock fraud: (1) increased co-ordination and information-sharing with other federal, state and local regulators and prosecutors, (2) stepped-up enforcement activities, including criminal referrals when appropriate; (3) targeted regulatory solutions; and (4) investor education. The Commission has made significant progress in each of these areas.

II. Inter-Agency Cooperation

One goal of the Task Force has been the development of stronger cooperation and collaboration with federal and state

regulators and prosecutors, and with the National Association of Securities Dealers, Inc. ("NASD"). The Task Force has sponsored nine regional meetings around the country for state and federal securities regulators and prosecutors. The purpose of the meetings has been to share information and discuss strategies for dealing with penny stock fraud. These meetings have been very helpful in forging a stronger network of communication and cooperation among regulators and prosecutors.

An example of this cooperative effort is the Florida Penny Stock Task Force, which grew out of a meeting sponsored by the Commission's Miami Branch Office, and includes the State of Florida, the NASD, U.S. Attorneys' Offices, the Federal Bureau of Investigation ("FBI"), the Internal Revenue Service ("IRS"), and other federal law enforcement authorities. This group now serves as a model for ongoing state and federal cooperation. The Florida task force has been meeting on a quarterly basis in order to mobilize and coordinate more effectively the resources of the various member regulators and prosecutors.

The Commission also conducted training sessions for staff from other federal and state agencies about securities fraud with a view to enhancing the number of civil and criminal cases brought by other authorities in the penny stock fraud area. On May 31 and June 1, 1989, the Commission hosted a two-day training program on securities and commodity fraud sponsored by the Justice Department's Securities and Commodities Fraud Working Group. The training program attracted over 150 participants,

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including representatives of the North American Securities Administrators Association, various U.S. Attorneys' offices, the FBI, the Internal Revenue Service/Criminal Investigation Division, the Postal Inspection Service, the Customs Service, the NASD, the Commodity Futures Trading Commission, the National Association of State Attorney Generals, and prosecutors from eight foreign countries. The Task Force plans to present a similar program again next year The Commission's staff also has conducted numerous training programs on penny stock fraud for FBI agents and Assistant U.S. attorneys located around the country.

The Commission believes that these cooperative efforts will continue to develop as the Commission, in the course of its stepped-up enforcement activities, participates in joint investigations and examinations, refers cases, receives referrals, and shares information with the other governmental authorities.

III. Enforcement Proceedings and Criminal Referrals

A. Commission Enforcement Actions

A second critical goal of the Task Force is to increase its enforcement actions in the penny stock fraud area and to increase the number of criminal referrals, when appropriate. In fiscal 1988, the Commission initiated 25 enforcement actions involving fraud or abuse in schemes that involved a penny stock. In addition, in 1988 trading was suspended in well over 100 penny stocks. Thus far in fiscal 1989, the Commission has brought 46

enforcement actions in this area and has suspended trading in 23 penny stocks.

A principal source of enforcement referrals in the penny stock area has been the Commission's broker-dealer examination program. During the summer of 1988, nineteen firms or branch offices were examined by the Commission's Miami Branch Office in a special "sweep" of broker-dealer examinations targeted at firms specializing in the penny stock business. Possible violations of the federal securities laws were identified and are being investigated. Possible violations uncovered included excessive undisclosed mark-ups, fraudulent distribution and trading of blank check offerings, parking securities in nominee accounts, failure to supervise securities salespersons, and selling securities by unregistered salespersons. The results of these examinations underscore the existence of a serious and widespread penny stock fraud problem. Many of the firms are relatively new to the securities business, many are going through recent rapid branch office expansion, and the penny stock selling and trading schemes may be national or international rather than local in scope.

Based on the results of the Miami "sweep," the Commission's staff identified approximately 300 broker-dealers throughout the country whose primary business is in penny stocks. During 1989, the Commission intends, with the help of the NASD and the New York Stock Exchange, to have an examination done of every broker-dealer in the country that deals primarily in penny stocks. The

examinations undertaken to date have already generated Commission enforcement cases and investigations, as well as disciplinary proceedings initiated by the self-regulatory organizations.

Some of the Commission's investigations involving potential penny stock fraud involve activities that reach across state and national boundaries. One of the Commission's significant recent penny stock enforcement actions is a case filed on August 3, 1989, in the Northern District of Illinois against Arnold Kimmes and 16 other defendants for various violations of the federal securities laws.1/ The Commission's complaint alleges that Arnold Kimmes, Thomas Quinn, and Michael Wright, among others, were engaged in a scheme to defraud the public in the registration, trading, and sale of two penny stocks, GSS Venture Capital Corporation ("GSS") and Max, Inc. ("Max"). Both GSS and Max, it is alleged, were sham corporations from their inception. The GSS scheme included figurehead officers and directors, placement of stock in nominee accounts, and stock price manipulations. The Commission's complaint alleges that over 2,000 U.S. and foreign investors from at least 45 countries lost in excess of $10 million through their investments in GSS securities. The Commission also alleges that Max had its price artificially inflated through a series of alleged manipulations -- its price rose from $.15 per unit (which consisted of one share of common stock and eight warrants) to over $4 per share

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1/ SEC v. Kimmes, No. 89 C 5942 (N.D. Ill. filed Aug. 3, 1989), summarized in Litigation Release No. 12210 (Aug. 9, 1989), 44 SEC Docket ____.

alone, and in Europe to as much as $6.50 per share. Recently, in a related criminal proceeding in the U.S. District Court of Nevada, the guilty plea of Arnold Kimmes to a two-count information involving the manipulation of penny stocks was unsealed.2/

Another recent Commission enforcement action is the injunctive action the Commission filed in February 1989 in the District of Nevada against Stoneridge Securities, Inc., a broker-dealer headquartered in Las Vegas.3/ The Commission's complaint named six persons and three corporations. The Commission's complaint charges that Stoneridge manipulated the penny stocks of several companies. The manipulation included figurehead officers and directors of an issuer, securities sold at artificially inflated prices to the public, the use of nominee accounts, false press releases and forged documents, among other misconduct. The shares of one issue were sold in the IPO at $.01 per unit consisting of common stock and warrants. Eventually, the common stock alone was sold at 1,000% more than the IPO price. The fraud also included a "no net sale" policy at Stoneridge -- that is, salespersons could not accept customer sell orders unless there were other customers ready to buy the equivalent or greater number of shares. This broker-dealer made no suitability

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2/ U.S. v. Arnold Kimmes, 89 Cr. 53 (PMP) (D. Nev.) (plea entered March 15, 1989), summarized in Litigation Release No. 12211 (August 9, 1989), 44 SEC Docket ___.

3/ SEC v. Stoneridge Securities, Inc., No. 5-89-096 (D. Nev. filed Feb. 3, 1989), summarized in Litigation Release No. 11995 (Feb. 13, 1989), 42 SEC Docket 1647.

determinations for any of its customers. In a related proceeding, Nevada has suspended the licenses of the firm's principals.

In SEC v. Goldcor, Inc.,4/ the Commission sued a Delaware corporation whose principal business activities were purportedly taking place in Costa Rica and whose stock was being promoted heavily by brokerage firms in Salt Lake City, Utah, and Tulsa, Oklahoma. According to the Commission's complaint, Goldcor claimed that it had in operation a unique extraction process producing millions of dollars worth of gold from the black sands on Costa Rican beaches. The complaint alleged that this claim was a fabrication and that the company had never produced commercial quantities of gold from its Costa Rican operations. The complaint also alleged that Goldcor and its principal promoters sold unregistered stock and had issued numerous false and misleading statements about the company's operations and revenues in order to inflate the market for the stock. The court has frozen certain of the defendants' assets and appointed a receiver. The action is pending.

A number of recent cases also have arisen out of penny stock activities taking place in the Pacific Northwest. The Commission's case against Colonial International Import, Ltd. is typical of these. In September 1988, the Commission brought a civil enforcement action in the Eastern District of Washington

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4/ SEC v. Goldcor, Inc., No. 88-612-CIV-ORL-18 (M.D. Fla. filed July 15, 1988), summarized in Litigation Release No. 11847 (Aug. 24, 1988), 41 SEC Docket 1176.

against a number of defendants, charging that they had committed various violations of the federal securities laws while promoting three blank-check penny stock companies.5/ The Commission's allegations relating to the manipulation of one of those stocks are illustrative of the types of activities and misrepresentations that the Commission sees over and over again in its investigations.

Among other things, the complaint alleges that in the course of their campaign to sell the stock to the public, the defendants made various material misrepresentations and omissions: telling investors that the stock was exempt from the registration requirement although, in fact, it was not exempt; failing to disclose the fact that the broker-dealer involved controlled the market for Colonial shares and was charging excessive undisclosed markups; misrepresenting Colonial's business activities and prospects, saying it had contracts that, in fact, were nonexistent; and failing to disclose that Colonial's new president had been convicted of a felony and owned a business that had gone bankrupt.

The Commission's investigation of this case involved extensive cooperation with state securities regulators in Washington and West Virginia. It commenced with an examination of a Spokane broker-dealer conducted jointly by the Commission's Seattle Regional Office, the NASD, and the State of Washington.

5/ SEC v. Colonial International Import, Ltd., No. 88-510-JLQ (E.D. Wash. filed Sept. 28, 1988), summarized in Litigation Release No. 11896 (Oct. 17, 1988), 42 SEC Docket 83.

Shortly thereafter, state authorities halted trading in Colonial shares. In September 1988, the Commission filed its case, asking the court to issue injunctions against all the defendants, and to order disgorgement from some of them. The Commission's complaint named seven persons and three corporations. Six of the defendants, including four individuals, have consented to the entry of permanent injunctions, and the action is pending against the remaining defendants.

B. Criminal Proceedings

As part of its enforcement effort in the penny stock area, the Commission is making more criminal referrals to U.S. Attorneys' offices and assisting the FBI and various U.S. Attorneys' offices in their criminal investigations of securities fraud. Too often the Commission's experience is that the people responsible for organizing, financing and executing stock manipulations in penny stocks are not deterred by the civil remedies that are currently available to the Commission. These civil remedies are viewed as part of the cost of doing business. Therefore, to deter more effectively penny stock fraud, the Commission is actively seeking to enlist the help of criminal prosecutors. I would like to highlight a few recent criminal penny stock actions.

The Commission staff investigating alleged manipulation of the stock of Memory Metals, Inc. provided data to the U.S. Attorney's office in the Southern District of New York and assisted in its investigation, which led to the entry of

indictments in March 1987 and November 1988 against the two persons involved with the manipulation.6/ The defendants have both pleaded guilty. The court sentenced them to prison terms of two years and one-and-a-half years, respectively, and, in addition, permanently enjoined them not only from working at a brokerage firm, but also from buying or selling any security or commodity.

In another case, the Commission provided the United States Attorney for the District of New Jersey and New Jersey state authorities with information gathered in an investigation of fraudulent and deceptive trading practices engaged in by F.D. Roberts, a penny stock broker-dealer. State and federal collaboration contributed to the criminal information later filed against the firm's former operations manager and its former regional sales manager, as well as the branch manager and two registered representatives at the firm's office in Boca Raton.7/ The U.S. Attorney for New Jersey estimates that as a result of its fraudulent and deceptive trading activities, F.D. Roberts allegedly realized gross trading profits of at least $67.2

6/ U.S. v. Hyman, Nos. 87 Cr. 212 (CSH) and 88 Cr. 742 (CSH) (S.D.N.Y. sentence entered Oct. 6, 1988), and 88 Cr. Misc. (LBS) (S.D.N.Y. sentence entered Nov. 2, 1988); U.S. v. Rodman, 87 Cr. 292 (MEL) (S.D.N.Y.) (sentence entered Feb. 16, 1989).

7/ U.S. v. Siesser, 89 Cr. 184 (D.N.J.) (plea entered May 23, 1989), summarized in Litigation Release No. 12166 (July 17, 1989), 44 SEC Docket 51; U.S. v. Eisen, 89 Cr. 185 (D.N.J.) (plea entered May 23, 1989); U.S. v. Humphrey, 89 Cr. 186 (D.N.J.) (plea entered May 23, 1989); U.S. v. Rutherford, 89 Cr. 187 (D.N.J.) (plea entered May 23, 1989); U.S. v. Napolitan, 89 Cr. 222 (D.N.J.) (plea entered June 23, 1989).

million in a three-year period ending in 1988, not including profits earned by illegal security sales in nominee accounts. The Commission also brought an action seeking injunctive and other equitable relief against F.D. Roberts and thirteen other parties alledging that the broker-dealer, together with others, manipulated the stock of Hughes Capital Corporation.8/

Another notable instance of such collaboration was the technical assistance and cooperation provided by the Commission's Salt Lake City and Denver offices in the course of the FBI's recent undercover operation in Salt Lake City. Undercover FBI agents let it be known that they were interested in purchasing a shell corporation into which they could then merge a private company. The shell company they ultimately purchased was Protecto Industries, Inc. The purported "scheme" involved listing the public company's stock in the pink sheets, and then manipulating its price upward.

The U.S. Attorney in Salt Lake City filed a 36-count indictment and seven criminal information in January 1989, charging ten individuals with criminal conspiracy, securities fraud, violation of the registration provisions and wire fraud. Defendants included a promoter who provided a fraudulently "revived" pre-1933 shell corporation, an accountant who created fictitious financial statements, transfer agents and three

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8/ SEC v. Hughes Capital Corporation, F.D. Roberts Securities, Inc. et al., No. 88-5238 (D.N.J. filed Dec. 13, 1988), summarized in Litigation Release No. 11939, 42 SEC Docket 742.

promoters.9/ Several of the defendants have entered guilty pleas.

C. State Enforcement Actions

State securities regulators also are playing a vital role in the penny stock area. One recent significant example is the series of enforcement actions that various states have initiated against Power Securities Corporation ("Power"). Starting in May 1987 when new owners acquired control, Power Securities grew from two offices and a sales staff of under 25 persons to a national network of 16 offices and a sales force of over a thousand. In 1988 and early 1989 a few states, including Nevada, Montana, and Florida, instituted disciplinary proceedings against Power based on allegations that certain offices had committed specific violations, such as conducting unauthorized trades, selling unregistered securities, or employing unregistered brokers.

In February 1989, the New York Attorney General filed an affidavit charging the firm with a pervasive pattern of manipulation and fraud, which included charging excessive markups, predicting rapid and high profits (as much as 35 percent in as little as several weeks), convincing one set of customers to sell a stock and another set to buy it at the same time, and refusing to process sell orders unless the customers agreed to invest the proceeds in other Power-recommended stocks. The court

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9/ U.S. v. Gleave, No. 89-CR-015G (D. Utah) (indictment entered Jan. 18, 1989), summarized in Litigation Release 12024 (Mar. 8, 1989), 43 SEC Docket 108.

granted a temporary restraining order prohibiting Power from soliciting any business in or from New York. Ten days later Power announced that it was terminating all retail sales activities nationwide. Subsequently, other states have brought proceedings against Power following New York's lead, including Pennsylvania and Ohio.

D. NASD Enforcement Actions

The NASD also has taken enforcement initiatives in this area. An example of the NASD's enforcement activities is the case it brought against two senior officers of Haas Securities Corporation, a New York broker-dealer.10/ The case was based on the firm's activities in October 1987 as a market-maker for the common stock and warrants of Cliff Engle, Ltd.

The NASD charged that Haas manipulated the price of the Cliff Engle securities as much as 124 percent in three weeks, raising its price quotations for the securities even when it was already the high bidder and there was no retail demand; that it effected unauthorized purchases in its customers' accounts; and that it discouraged, and refused to execute, customers' sell orders. The NASD fined the firm's president $100,000 and barred him from the industry for five years, and imposed lesser sanctions on the chairman of the board. The NASD also cooperated

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10/ Haas Securities Corp., No. MS-675 (N.A.S.D. Nov. 25, 1988); U.S. v. Aalanian, No. 89 Cr. 3 (S.D.N.Y.), Jan. 5, 1989; U.S. v. Laff, No. 89 Cr. 228 (S.D.N.Y.), March 20, 1989.

closely with the U.S. Attorney's office in its investigation, which resulted in criminal indictments based on the same charges.

The Commission intends to maintain a strong enforcement presence in the penny stock area. It also intends to continue to work with the NASD and other state and federal authorities to maximize the impact of our collective law enforcement powers in this area.

IV. Regulatory Initiatives

A third goal of the Task Force's work involves the review of the Commission's regulatory structure and the consideration of regulations targeting penny stock fraud. A broad range of ideas has been discussed by the Task Force as well as with representatives from various state and federal agencies. As a result of these discussions, the Commission recently took two regulatory initiatives.

A. Rule 15c2-6

The Task Force has found that one of the key elements in fraudulent penny stock schemes is the use of high-pressure and misleading sales practices by broker-dealers. High pressure, unsolicited telephone calls to unsophisticated small investors appear to be the primary means used by penny stock firms to sell securities to new investors. Often these high-pressure sales tactics result in small investors purchasing unsuitable and highly speculative penny stocks recommended by the broker over the phone. Typically, an investor receives a call from a

salesperson, who works out of a boiler-room-type operation, and who may be located in a state different from the investor. The salesperson seeks to pressure the investor to purchase securities of a thinly-traded penny stock, whose market is controlled or dominated by the brokerage firm involved. Most likely, the investor has never heard of the recommended security or dealt with the brokerage firm employing the salesperson.

On August 16, 1989, the Commission adopted a new Exchange Act Rule 15c2-6 to address this problem. It will take effect on January 1, 1990. The rule has been carefully structured to target the problem of sales practice abuses that are common in the sale of penny stocks.

Rule 15c2-6 is intended to assure that salespersons recommending certain penny stocks secure basic financial information about the investor and make a written determination that the securities being recommended and sold are suitable for the investor based on the investor's financial situation and investment objectives. The rule will require the investor to confirm both the accuracy of the financial information given the firm and his/her desire to purchase the security on the first three investment occasions. This will give the investor time to investigate and reflect on the investment decision, assure that the firm makes a suitability determination and provide an audit trail for regulators. Finally, these new recordkeeping requirements may enable the Commission to bring penny stock fraud enforcement cases more quickly.

B. Proposed Amendments to Rule 15c2-11

The Commission also has approved for publication proposed amendments to Exchange Act Rule 15c2-11. This rule regulates the submission and publication by broker-dealers of quotations for certain over-the-counter securities, including those traded in the pink sheets. The Commission is concerned that broker-dealers may not be complying with the rule's requirements to have up-to-date information on an issue when submitting a quotation for a security, particularly following the expiration of a trading suspension. This concern has grown because many penny stock frauds may be facilitated by the activities of broker-dealers that advertise bid and ask prices as market markers in the penny stocks. The market-making activity may give a sense of legitimacy to the prices at which the penny stocks are being sold by boiler-room operators.

One of the main requirements imposed by Rule 15c2-11 in its current form is that broker-dealers gather and maintain on file certain information about the issuer. However, the current rule does not explicitly require the broker-dealers to review this information. The proposed amendments would add such a requirement.

In addition, whenever a trading suspension is ordered by the Commission, the proposed amendments would impose an explicit requirement that the broker-dealer obtain and review a copy of the trading suspension order and review its file of issuer

information in light of the information contained in the suspension order.

These proposed amendments are designed to encourage broker-dealers to review the information they gather about an issuer's financial status, business experience and prospects before they publish quotations. The revisions are intended to alert broker-dealers to situations where their quotations might unwittingly facilitate fraudulent or manipulative schemes, th . adding credibility to the illusion of a legitimate market for the securities involved in the fraud.

C. NASD's Schedule H

The NASD also has recently implemented a very significant regulatory initiative. In May 1988, the Commission approved an NASD rule change adopting a new Schedule H to its by-laws. Schedule H requires every NASD member firm to report price and volume information for all its principal trades in a non-NASDAQ equity security each day when the firm's trading in that security meets certain minimum reporting thresholds (an aggregate daily volume of 50,000 shares or $10,000 in aggregate value).

The reporting requirement was implemented in two stages. Phase I, which started on September 1, 1988, required such reporting for transactions in securities cleared through the National Securities Clearing Corporation. Phase II, which started on August 1, 1989, requires such reporting for transactions in all non-NASDAQ securities. The schedule requires

that the information be entered electronically by 9:00 a.m. on the day following the trading.

Before Schedule H went into effect, there was no systematic way to collect major price and volume movement on transactions in the penny stock market, which consists primarily of non-NASDAQ OTC securities. Schedule H will allow the NASD and the Commission to compile a much more accurate picture of trading activity in pink sheet securities and to monitor the activities of penny stock brokers much more effectively. It represents a major market surveillance development and should significantly improve the Commission's and the NASD's enforcement efforts in the penny stock area.

V. Investor Education

The Task Force also has focused on increasing investor awareness of how to recognize and avoid fraudulent penny stock schemes. The Task Force has written and distributed two investor bulletins on penny stock fraud. The first, entitled "Beware of Penny Stock Fraud!," provides basic information about penny stocks, describes warning signs of penny stock fraud, and recommends steps investors should consider before investing in penny stocks. The second, entitled "Penny Stock Telephone Fraud," gives examples of the types of tactics sometimes used in high-pressure telephone sales campaigns. It also recommends steps investors should consider to reduce their chances of being

victimized by penny stock fraud. A copy of each investor bulletin is attached to this statement.

These bulletins have been published as part of the Commission's "Information for Investors" series, and are routinely being sent to persons writing or calling the Commission with complaints relating to penny stock fraud. In addition, the Commission's regional administrators have sought the assistance of banks and utility companies in their areas, asking them to include the bulletins with their monthly billing or account statements. For example, our Miami Branch Office has arranged for over 1.8 million copies of the Commission's "Beware of Penny Stock Fraud!" bulletin to be distributed by banks, savings and loan associations, and major utility companies in Florida. The Florida Division of Securities currently is preparing a Spanish version for distribution to the public.

VI. Conclusion

In conclusion, the Commission and its Penny Stock Task Force are committed to continuing their efforts to protect the investing public from penny stock fraud. Over the last ten months, the Commission has made significant progress in increasing enforcement actions and criminal referrals, proposing regulatory initiatives, providing investor education, and fostering cooperation with other law enforcement authorities. In addition, in 1989, the Commission sent to Congress two legislative initiatives, H.R. 1396 and S. 646, the Inte national

Securities Enforcement Cooperation Act of 1989 and H.R. 975 and S. 647, the Securities Law Enforcement Remedies Act of 1989. Although not specifically targeted toward the penny stock fraud problem, each would provide the Commission with greater enforcement capability which it could use in attacking penny stock fraud. The Commission thanks the Committee for this opportunity to report on its activities in this area.

Senator BRYAN. Mr. Goldstein, thank you very much for your testimony. You have each explained the dimension and the magnitude of the problem. Now let's talk about some of the solutions. If I might ask the Secretary of State first a couple of questions.

What kind of information is usually available for the investor who is being solicited by these penny stock telemarketing solicitations? Is there any kind of information that's available on the companies that they purport to be soliciting for so that the investor can himself or herself make an independent assessment as to the value of the prospective investment?

Ms. DEL PAPA. Mr. Chairman, I think that's a really good question because unfortunately one of the red flags and one of the modus operandi of the telemarketing area is that oftentimes the investor has very little information and one of the things that tips you off—I mean and oftentimes they're told they have to make this decision today immediately.

The decision—it's a heat of the moment type decision where oftentimes they don't have the opportunity to buy some time to look at a prospectus or to talk to someone reputable or someone even that they know to explore it further. Unfortunately these decisions are made very quickly and that's what often leads to trouble.

Senator BRYAN. What kind of information is required to be registered with the Secretary of State Securities Division as it relates to this kind of transaction? Is there a registration statement required? Is some kind of information made available to your office, for example?

Ms. DEL PAPA. I'd like the Deputy Secretary of State for Securities Division to respond. He's better qualified to answer that question.

Senator BRYAN. Sure. Delighted to have you with us, Sherwood Cook.

Mr. COOK. Basically when the stock is initially sold to investors that information is really quite good. There is a very specific rule that tells issuers what information they have to provide. Financial statements are provided in that prospectus and so at least initially the information is good.

What happens is after that initial offering the secondary market begins and that's where the telemarketers step in and all of the sales reps and the brokers firms step in and they take it from there.

Senator BRYAN. So they're really in the secondary market is what you're saying.

Mr. COOK. That's where the problem is. Particularly the small companies have a history of reorganizing. New people come into the companies and the company changes operations and at that point the information that's available to investors becomes very minimal if any at all.

Senator BRYAN. How is it determined whether or not a particular company will be, you know, a penny stock company? At what level is that determination made? At what point does the fraudulent motivation begin insofar as those companies that we identify as being illegitimate as opposed to the legitimate penny stock operators? The Secretary of State acknowledges that there is certainly a legitimate purpose and there are legitimate companies that are

involved in this enterprise but our focus clearly is do these ever originate for an honest purpose and then get transformed into something else? Or is it rather that the ones that we're having problems with occur at their very genesis, and they are designed as a medium of perpetrating fraud upon unsuspecting investors?

Mr. COOK. Well, penny stock is a very generic term that really doesn't mean much. Usually penny stocks refer to stocks that are trading now under $3. It used to be a dollar and now they've raised that level to $3, but for the most part when people talk about penny stocks they talk about stocks that are not traded on an exchange not on the NASDAQ system but stocks just traded in between penny firms and that's why you get the information because these stocks aren't on an exchange.

The exchanges require certain information. NASDAQ requires certain information. It requires a certain level of assets and earnings. When they don't have those additional requirements in an exchange or NASDAQ, then, you know, it's those companies that gain because they're at those requirements. They don't have that information available.

Senator BRYAN. Let me try to frame my question a little bit more precisely: but are there companies that in their inception are legitimate but thereafter are captured by manipulators, those who are involved in the very kinds of activities that you've all graphically described today? Or did the legitimate companies stay legitimate and the illegitimate ones are born, so to speak, with the purpose of fraud in mind?

Mr. COOK. Well, I'd have to say there are legitimate penny stock companies that start out legitimate. They stay legitimate. They sometimes get bigger and better and sometimes they just fail for regular business reasons but there again yes, there are companies that start out legitimate and they're taken over by the scam traders.

Senator BRYAN. A jurisdictional question if I may. Based upon the Nevada legislation that you were successful in pushing in 1987, and as I recall that was sunsetted then we got it back in 1989, are there any jurisdictional problems that you have in terms of interfacing with the SEC or the interstate enforcement activities that we need to specifically focus on as we look at this legislation? Probably I guess you might be the one that might be able to discuss this with us. Mr. Struve shared more generically his ideas on telemarketing fraud, areas that we might have some concerns about and would consider in developing this federal legislation. Maybe you might want to——

Mr. COOK. We have found that jurisdiction is not a problem. Both the SEC and the state have concurrent jurisdiction when you're talking about fraud so that hasn't been a problem. What's been more of a problem is interest. Is the SEC interested in handling a situation that may be confined to one state or may be of relatively small dollar amount?

Senator BRYAN. As for my last question of your office, and one that I'm sure is of general interest to most of the audience, relates to the mechanisms that are available either by reason of the criminal process at the state level or a civil recovery process to recover something for the victims of fraud from those who have participat-

ed in this kind of fraud. Would you describe basically what is available, and the Secretary of State commented I think generally on that in her initial statement, but what is the effectiveness of those remedies at the state level? Is there anything that needs to be done to enhance those remedies?

Mr. COOK. Well, as Secretary of State described, we have a state of the art statute which has very, very good remedies both criminal and civil. On the civil side of course investors can seek recovery. He can seek penalties. The state can seek fines up to $25,000 for an incident. We have criminal prosecutorial powers so the remedies are very good.

Again, as far as the staff we have limited staff time so we have to work around that and that will come but as far as the tools we have the statute, the remedies that are provided in the statute. Nevada has a very, very good statute.

Senator BRYAN. Most of these people that are victimized by this kind of fraud as you've all described it to me both during the hearing this afternoon and previously suffer the loss of a lifetime savings. So to say to that individual that there is a mechanism available in the law that you may retain your own private counsel and yes, you can file suit in the court system, is an illusory remedy. I'm not being in any way critical of certainly your office or in no way critical of the legislature in terms of what it has tried to do, but is there a mechanism available at the state level whereby a civil remedy can be sought almost in the form of a class action on behalf of those who have been victimized by a particular type of penny stock fraud in which there would be a recovery, not just the civil fines or penalties, not just the criminal prosecution, all of which is important, but the recovery of whatever assets may be remaining? Admittedly oftentimes, that may not be much but in effect they are an advocate for the victim, if you will.

Mr. COOK. Well, the statute does provide for the state to go in and recover whatever it can for investors but unfortunately this is a fraud problem and the characteristic of fraud is that these people come in, they do the dirty work, they use the money, they're gone, so unfortunately in most instances there really isn't much to recover for fraud victims even though there is a statute that will provide for it.

Senator BRYAN. Regrettably, that's been our experience at the Federal level with the savings and loan fraud, by the time we put into legislation $71 million and directed the Attorney General—I think he's a very sincere man. I knew him as a former Governor when he served as the Governor of Pennsylvania, but by the time you get cranked on that process unfortunately the Jaguar is gone, the lakefront condominium is gone and these people do not have much in resources to reimburse or compensate the victims of this activity. We thank you very much.

Mr. COOK. Thank you.

Senator BRYAN. Mr. Struve, you've raised the jurisdictional question and you talked in terms of not preempting the state in the efforts which it's undertaken and I agree. I think you know my own predilection there as one who worked in the state office with you at the state level and later as Governor.

You're probably aware that the National Association of Attorneys General and the FTC does have a database as it relates to telemarketing fraud. You might want to take a look at that and see if that type of a model is what you contemplate in recommending to us to consider that type action.

Mr. STRUVE. I'll be happy to take a look at it, Senator. I will point out to the Committee that you will find from state to state there are different arrangements applied for empowering officials to take action against fraud. In our state the primary jurisdiction has been placed in the Commissioner of Consumer Affairs who is represented by the Attorney General in bringing an action and enforcing our state fraud statutes so the database you've referred to I think would be an excellent place to begin in looking at where the shared jurisdiction would occur as between the federal government and state government but I certainly think that the statute you consider should allow for each state's unique arrangements as to who can share that jurisdiction——

Senator BRYAN. Sure.

Mr. STRUVE [continuing]. With the federal agency.

Senator BRYAN. Well, there are a lot of different models as you and I know in determining how that's handled on a state by state base. One of the problems that we face at the federal level in defining telemarketing activity that we want to regulate is not to cast the net so broadly that we bring under its jurisdictional coverage activities which have not been a problem in the marketplace.

For example, the pizza solicitation by telephone, and some very, very legitimate catalog companies some of which are located in Nevada, as you know, who engage in that type activity by phone and by and large have not been the kind of problem that we're talking about here today. How did you define it at the state level and what words of counsel would you offer to us at the federal level in defining a statute that is sufficiently narrow, ascertainable so that we get the bad guy and do not get ourselves involved so broadly that we are negative in focusing our energies?

Mr. STRUVE. You've asked a very good question, Senator, and I'm afraid I cannot come up with the answer to the Rubik's Cube you've put before us. The way the Nevada legislature answered that question was they—and I have attached to my statement the Nevada statute. Basically what they did is they defined two terms that relate to what you are getting at in your question.

The terms are seller and salesman. These were largely the result of testimony provided by the law enforcement officials in the State of Nevada, most specifically the District Attorney's office here in Clark County and the District Attorney's office up in Washoe County.

You will find that the definition of seller is very broad and it basically covers anyone who sells goods or services over the telephone and that probably—oh, and then related to that in the next section is a long list of exceptions. I did not go into those in my oral testimony because I thought it was too long and not really necessary and I'm sure you will have some questions in your mind as to why some exceptions were written in and maybe not others. It was probably the function of the legislative process that I know, Senator, you are very familiar with.

Senator BRYAN. It works its ways sometimes mysteriously in a very arcane fashion, Larry, I know.

Mr. STRUVE. Yes, sir. And you must also keep in mind that the Nevada legislation was based upon establishing a licensing mechanism and many of the exceptions relate to firms that are already regulated under licensing schemes. For instance, a firm that is regulated under Chapter 90 of our NRS is not required to be licensed as a telemarketer under A.B. 142 and we are not proposing that you establish a federal licensing scheme.

I hope that is very clear in the record and therefore the inferred approach may not be particularly germane to the problem that you've posed in your question. What I tried to do in my statement and with the help of Shari and her staff is to indicate some of the key elements of a boiler room operation that we think are distinguished features from those of the other firms that are very legitimately involved in selling goods and services.

You recall that the offer of a prize or premium coupled with an immediate placement of an order coupled with immediate turning in of the credit card with a delay of the ultimate receipt of the goods or services are some characteristics that you might look at that would be a start in defining what the scope of, you know, your statute might be.

I'm not going to represent to the subcommittee that this is going to be an easy task and I understand that the Congress has been wrestling with this dilemma for the past several years. But I think that, as you have indicated, we've recognized in the State of Nevada that there can be very, very good and legitimate telemarketing firms that are not regulated in these other areas but which are offering a very definite service to the public. And even those that are not subject to licensure under the Consumer Affairs Division we hope will set up within their own operating procedures devices to eliminate the possibility for fraud and deception.

Just this morning I visited a firm that's been doing business in this town for a number of years, and they have a system in which the initial order after it is placed by the customer is then verified 24 hours later. And in the verification process they have a very serious number of questions that are put to the consumer to make sure that the consumer understood the terms of the order, the cost that is involved, that they're not guaranteed any particular price but what they get is purely by chance. Many of their sales of course wash out in that process but they are left with very legitimate sales and I think that a company that is engaging in that kind of prudent business practice ought to be encouraged because they're using some very state of the art marketing techniques. But for those that don't do that and which have the elements I alluded to and will leave that consumer hanging with an unlimited product or service with no redress except to come and complain to an agency like ours or a federal agency, I think that's where you need to start focusing on building a statute that's going to control that activity.

Senator BRYAN. I would ask you the same question that I asked Secretary of State Frankie Sue Del Papa, and Mr. Cook, and that is you described the new statute as providing both civil and criminal penalties and the question is basically for so many victims by the

time they come to you, they have been thoroughly bankrupted. They do not have the means to hire their own attorney.

Some of the remedies that we provide in good faith, and I don't again criticize in any way the efforts that you or Shari directed in getting this legislation approved, but what do we have available by way of state procedures that assist folks who literally have been victimized out of their last dollar of savings to file actions on their behalf, not exclusively of criminal or civil sanctions but at least a method in which the state serving as an advocate on behalf of the victim may be able to recover, as small as it is, at least some potential amount so that it's not a total loss. Even though it's not an optimum situation, at least we're able to do something for them.

Mr. STRUVE. In response to that question A.B. 142 which is the licensing statute does not I believe provide for private cause of action. I think what the legislature was trying to do was put a handle on the current unregulated firms so that if they did engage in activities that generated the complaints, they could at least lose their license and they would be stopped from doing business in Nevada.

With respect to the consumer who wants to pursue a private cause of action where the existence of civil and criminal penalties doesn't mean too much when they have lost a huge sum of money I believe under the preexisting Deceptive Trade Practice Statute which your staff will find in Chapter 598 of the Nevada Revised Statutes that they are allowed to bring action against those who have engaged in a deceptive trade practice to seek restitution.

I really think as a practical matter that that is a very difficult task for most people who have been victimized by a fraud situation because hiring an attorney, going through the process of attaching assets, going through the process of executing a judgment, particularly if you're dealing with a firm that may not be around if there's a large number of complaints, may make that available remedy under state law illusory.

Under A.B. 142 there is a bond requirement of $50,000. If you have a major operation, that obviously is not going to go very far in providing restitution but one suggestion that I made in my presentation is that if there are assets that a firm that's doing national telemarketing has in other states, you might want to look at giving some kind of remedy through the federal legal system whereby those assets that may not be located in the state where the state officially is bringing the action but where the asset could be attached in another jurisdiction and can clearly be shown to be part of that firm's operation under their control then at least through the methods of prejudgment attachment you might be able to preserve some assets so that if you do get the judgment there's something you can execute on. Short of some kind of a guarantee fund, which I don't think taxpayers are interested in supporting, I frankly don't know how to otherwise respond to your question.

Senator BRYAN. We've done some things that helped us reach out jurisdictionally with some legislation we've proposed for the Federal Trade Commission. Shari, do you know under your provision of deceptive trade practices is there a mechanism that allows the state, your office or the Attorney General's office or the two acting in concert, to file a proceeding akin to a class action on behalf of a

group of victims of any type of deceptive trade practice violation so that you can ostensibly recover what little may be remaining on the part of the firm that has been engaged in this kind of activity?

Ms. COMPTON. Mr. Chairman, one of our procedures is recovery of monies for consumers. Normally we do that under the administrative control that we have in the division. We would file the case and then usually settle the case out of court with the consumers that have filed with us getting their money back and then less the cost of investigation.

I would think probably in the last three or four years one case was quite—it was 250,000 that we did receive and the federal government received the same. And so we have been effectively able to do that if they want to continue business. If they go into bankruptcy like any business or do chose to go to another state, then it becomes sometimes impossible for us.

Senator BRYAN. I'd appreciate it. Thank you both very much for your comments. Mr. Goldstein, you've heard the testimony by the officials at the state level. Clearly I think the thrust of their testimony is that they want to work together with you and you've received accolades from the Secretary of State personally for the efforts that you've made and Mr. Ruder as well.

What do we need to do at the federal level to build upon the enforcement mechanisms which have been upgraded and modernized at the state level both in the Securities Division or telemarketing fraud generically, which is broader I know than your charge. But how can we strengthen those, and not as they say to preempt because you've got a full plate yourself? You're not interested in taking over those areas where the state can handle the job and is eager to do so. What can we do in terms of approach?

Mr. GOLDSTEIN. The Commission has sent to Commerce a legislative proposal Securities Enforcement Remedies Act of 1988 which requests I think two very valuable additional enforcement tools for the Commission. The first is the ability to find violators of the federal securities laws. We now can only fine individuals who engage in insider trading. That was under the Insider Trading Sanctions Act of 1984. The new provision would provide for fines of up to a hundred thousand dollars per individual and $500,000 for entities that violate the federal securities laws. And that would be a very effective remedy for those violators who actually have the money.

Now, I want to put this in context. I share the view that's been expressed that in many of the cases because we seek to obtain recoveries for investors through disgorgement efforts it's very hard in a lot of these cases to actually recover monies. The other tool would be the ability to bar individuals from being officers and directors who have violated the federal securities laws if their violations were the kind that would be repetitious and harmful for investors.

I think that would be very helpful because we do see many instances where we'll bar someone, an individual from being associated with a broker dealer from being in the securities industry and they come back as a player by being an officer or director of a company that stock is being manipulated and that won't necessarily reach the person who is behind the scenes and doesn't actually have a title or role but it will help with respect to the actual offi-

cers, directors of the company so I think those two things will be helpful in an enforcement context.

I think the kinds of developments that I talked about in the criminal area, criminal enforcement area, the undercover operations is a very, very promising approach because I do think the criminal law enforcement against repeat violators and people who just have no regard for civil injunctive relief will help deter this kind of violation.

Senator BRYAN. Mr. Goldstein, when you refer a matter for criminal prosecution am I correctly informed you presently refer that to the U.S. Attorney's office for appropriate action or do you handle that within your own division?

Mr. GOLDSTEIN. Well, actually we have a much more informal referral system now. We generally provide access to U.S. Attorney's offices or that could be state authorities as well and many times it is state authorities where if we know that a state or U.S. Attorney's office would be interested in our particular case, we'll give them a call and if they request access to our files there's procedures they have to go there. We'll give them access to the files and provide them with all the information that we have. Formal referrals are not really done very often any more.

Senator BRYAN. But you do have the authority then to refer a matter to the state for prosecution where you think that the circumstances lend themselves to state prosecution and then you have another mechanism, albeit informal, that is to prosecute at the federal system, I take it.

Mr. GOLDSTEIN. You're correct, and in our informal mechanism works with the states as well as with U.S. Attorney's office. I think it's worked very effectively. We're able to provide information rather quickly. A lot of our states ask for access to our files as well as U.S. Attorney's offices and we encourage that and that's one of the purposes of the regional meetings that we had is to encourage other states or state and other federal law enforcement authorities to aid us in these cases.

Senator BRYAN. Are there any legal impediments that you have currently, other than the one you've indicated, the absence of authority under certain circumstances to impose a fine. That's being corrected in the legislative package that you put together in 1988, but are there any other legislative impediments that we need to be aware of as we look at the legislative approach to solve some of these problems?

Mr. GOLDSTEIN. Well, we as a task force are reviewing both the legislative and regulatory frame work that penny stock fraud operates in and as part of that we came up with Rule 15c2-6 which——

Senator BRYAN. Why don't you tell the folks a little bit about that. I think I know what that is but——

Mr. GOLDSTEIN. Okay. Well, rule 15c2-6 is a rule that sometimes, as I said, is called the penny stock rule and it's really designed to take two of the elements out of penny stock fraud and that is the lack of suitability of penny stock investments for many investors and the high pressured sales techniques that are used to sell them.

On the suitability side I gave the example of the 76-year-old man who lived in subsidized housing and was supported by Social Security. That under the rule could not take place. The way the rule

would work is that a firm would have to obtain information about each investor, the investor's financial situation, investment and experience and make a written determination as to whether or not penny stocks are suitable for that investor.

The firm would then have to send a copy of that written determination to its investor. The investor would then sign it and return it to the firm. The investor could not be sold a penny stock prior to that being completed and right above the signature line where the investor would sign would be a statement that's highlighted, "Do not sign and return this if it does not accurately represent your financial situation and objective." So hopefully that will take, release unsuitable investments.

The other side of it, and this will also be highlighted, is that a transaction cannot take place until the brokerage firm receives a written agreement to the transaction from the investor so that through the first three investments the investor actually has some sign and that means that you can't enter into an agreement on the telephone. You can only do it in writing after the telephone call was made and hopefully the broker who says, "You've got to buy now. You've got to buy instantly and you don't have to think about it, just trust me," well, that will end because the phone will have to be hung up. A person has a chance to reflect on it, hopefully obtain some good advice and then make an actual determination as to whether or not they really want to invest in that particular stock.

Now, there are exceptions from this. There's exceptions for people who are credited investors. That means that they're basically wealthy individuals who are sophisticated and have had an ongoing relationship with the brokerage firm. We don't see this, and I want to make it clear that this is not going to be a cure-all. We hope it will work. The kind of people who engage in penny stock don't always observe the niceties of the law.

To the extent that it's violated we have an examination process where hopefully we'll define the violations. If it's violated by the use of forged documents or forged papers, that will really help criminal prosecutions so we do think it will be an effective tool to end this problem and we'll see how it works.

Senator BRYAN. And my last question, Mr. Goldstein, is along the lines that I asked each of the other panelists and that is in your judgment do we have adequate remedies under the existing law and if not what changes would you make in terms of remedies that are available to those who have been victimized as we've characterized them who simply have no money left to hire their own attorney to seek redress in the traditional avenues that are available in the court system. If you have no money, even though the courts are open, the laws are strong, the penalties are there, the legal result is clear, it's a remedy that's illusory. It's just not there. The court system unfortunately is not available for people who do not have the resources in all too many cases and I'm not referring now specifically to this. If you'd comment on that, Mr. Goldstein, and share with us your insight.

Mr. GOLDSTEIN. I agree with you. I think that's the worse aspect of this problem is people whose money really without recourse to obtain—in the federal securities law system there are provisions

for class action lawsuits which really helps the people who can't afford to fund a lawsuit. There's also the possibility of using arbitration procedures for example that the NASD has.

I don't want to overstate the likelihood that people will recover money when they've been the victim of penny stock fraud. I fear that in all too many cases the money is just gone but there are class action lawsuits. There are arbitrations and I think that the threat of it and the actual carrying on of these kinds of civil remedies by wronged investors are a helpful part of the enforcement process and they will help end the problem if people get hit with large enough judgments and the money that they squirreled away someplace is actually found.

Senator BRYAN. Mr. Goldstein, we thank you. We thank each of the panelists for your testimony. It's been helpful and I'm sure that a joint and cooperative state and federal effort is going to emerge as a result of these kinds of hearings and others. We appreciate your testimony. We're going to next hear from our second panel which will consist of Nevada victims. Before doing so let's take a brief ten minute recess and we'll hear from some of our fellow Nevadans who can share firsthand their experience in this area.

[Recess taken.]

Senator BRYAN. The subcommittee will reconvene and we have our second panel of Nevadans who have been affected firsthand by the type of activity which was described in some detail by our first panel. Joining us this afternoon is Mr. Mordechai Yerushalmi. He and his family were victimized of over a hundred thousand dollars; also, Mr. Mike Tony who invested in Power Securities, one of the institutions that was described in testimony by the Secretary of State and others. Fortunately Mr. Tony was able to get out but many of his friends were not so fortunate.

We have with us Mr. Don Garvin who was nearly a victim. He had written a check out for $2400 but was fortunate enough to have been gone when a messenger arrived to collect the check. A fortuitous event, Mr. Garvin. Finally we have Mr. Mark Dzarnoski, who worked in the penny stock business for several years before he went to work in the Enforcement Section of the Securities Division. He knows the operation of these companies from the inside and is here today to suggest some reforms that we might consider in our legislative program.

So first I'd like to call on a friend of mine, Mordechai, to share with us, if he will, his own experiences and then we'll address each of the other witnesses. It's nice to see you here today and we appreciate your attendance as well as each of the witnesses who joined us this afternoon.

STATEMENT OF MORDECHAI YERUSHALMI

Mr. YERUSHALMI. My pleasure and I'm speaking on behalf of my family. It was in 1988 a person that I know pretty well called me over the phone and he said he's got a friend he would like to bring him to the store and buy some jewelry and he would appreciate if I give him a special price so he came in with him and I gave him very good price on jewelry that he bought and he gave me a check and he left.

A few days later he calls me. He said, "Mordechai, I appreciate the good deal that you gave my friend. My friend wants to talk to you." So I get on the phone and talk to him and he says:

Because you took care of me, I want to take care of you. I'm involved with stocks and if you invest with me, I can give you a very good return on your money in a short period of time and I got a new one coming out and it's, I would like you to get involved with it because today or tomorrow is the deadline.

So I guess I believed the guy and I went along with it and I invested some money and a few days later he comes to me and he says, "See, that investment you got you already got so much. Why don't you get me some more friends to get in with the different stock that we are coming up with," so I called some of my friends and family and they put some more money in some different stock and he said it would take me about a week to two weeks and I'll have a good return on your money.

In the meantime I told him, "Well, why don't you give me my investment back and let's roll the profit." He said, "No. I cannot do it yet. Let me roll it a few more times, make you a little more profit then we'll go along with that," and he started giving me all kinds of names of different people in town that I know that apparently invested with him to make me feel more confident.

A week passes by, two weeks passes by, no changes made and then all of a sudden he calls me again and he says, "You know what? There's a new stock coming out and if you want me to be able to roll your money faster and give your investment back, this is something to do with an anti-AIDS drug that is going to be very strong and everyone's recommending it," so I guess I went along with it and I haven't seen a return yet so I kept calling him and said, "So what about my investment? I'd like to get it." "Well, we're moving to a different clearinghouse and we cannot do it right now. Give me a few more days. Give me a few more weeks."

It kept on going like that and all of a sudden I called to talk to the person that brought him over to introduce to me and he was no longer with the company so I called Mark Benninger, whatever his name was that made all this wheeling and dealing and I told him, "What's going with the investment?" "Give it a little more time and I'll be able to take care of it," and all of a sudden I saw on the news that Power Security has some problems with them in the New York office and I called him.

He said, "Don't worry. Everything is fine. You'll have your money. You'll have your profit," and that was it. What's more unfortunate about it is that if in a certain fiscal year it shows profit, so-called profit on the paper, you have to pay taxes on those profits too so it's not enough that you lost the money, you got to come up with extra money to pay the taxes on those so-called profits so that's went on for a while and apparently he, the company was closed down and he gave me a certain address to write a letter to to get the certificates.

I have the certificates. I don't know. As far as I know they're worth nothing and he moved to another company and from there he was either let go or left and that's the last I heard of him and that's where I stand right now.

Senator BRYAN. I appreciate your sharing. We'll be back with some questions in a moment but let's hear from all the witnesses

and then we'll talk about this. Mike, you were a little bit luckier it seems than Mordechai and some of your friends that you worked with. Why don't you tell us your experience, what happened, how you were approached and how you were able to save yourself in the nick of time.

STATEMENT OF MIKE TONY

Mr. TONY. First, Senator, I'd like to take this opportunity to thank you and your staff for coming out here and taking an interest in us. I know we're just the little people and I appreciate you coming out here and helping us out in our dire of need.

I was very fortunate, maybe blessed. Maybe I was a guinea pig. Maybe they set me up. I did not know anything about a penny stock. I never even heard of it. I do have a stockbroker which I do business with, Prudential-Bache, and I have made money in the stock market. When a friend of mine received this job he called me and asked me to come into this penny stock. I didn't know anything about it so I kind of checked up on it. I did get a chance to meet the owner. I wanted, I said, to see what I was doing and I did see the pamphlet that they had. It was impressive because I felt that they were legitimate. They had been in several cities. Denver, they had offices in New York, Santa Barbara, Las Vegas—they were just moving into Las Vegas.

Being in the stock market I do not read the accounts. I have confidence in my broker. It's like when I go to a tailor. I don't pick out the material. He picks it out for me. When I bring in a carpenter, he's the guy that pounds the nails. I don't know anything about that. So I take confidence in my broker and a friend of mine became a broker.

I asked him—he asked me if I wanted to invest in it. When I called up and checked it out and I tried to do my homework the guy said, "That's a penny stock. You can't make any money with penny stocks. That's a gaff. It's a scheme." That's the first I heard of Robinson. That name came up. This is like blinder Robinson. They scammed the people. My man said, "No, this is not. This is a trust. This is this," so I gave them $10,000. I say, "You know, go ahead, throw the dice with it, see what happens."

I went in there with my eyes open. Three, about ten days later he called me up. He said, "That 10,000 you gave me is 12,500. We're going to put it into this stock. I'm going to roll it into this stock." I said, "Fine." I said, "About how long?" Well, this was in August. He said, "Around November," and I said, "How much do you think—how high do you think it's going to go?" Because I set a number.

I always found out pigs get fat; hogs get butchered so I said, "What number do you think we should sell at?" He says, "When it gets to this number, we'll sell." I said, "OK. When it hits that number I'll sell and if it goes higher, then fine."

November came. I called him up. I said, What's—"Well, it doesn't look too good," then January and then February and then February came and he said, "I'm going to take you out of this stock. Put you in this stock. You got $12,800. I'm going to put you into this stock." I said,

"Let me see the check. I'll tell you what I'm going to do. I got some friends of mine who would like to invest. I want to show them the check. If I show them the check that I made money, then they're going, you know, to invest."

So they sent me the check. When I got the check it never saw daylight again because, you know, when the guy told me from November but I did make money and what I did I did give him names of friends of mine who play the stock market and there were about 30 people not only in this state because you know me, Senator, I have—I work in the casinos. I have people from all over the country and these people are players. I gave them names.

I said, "I did make money. It looks legitimate. I got a check." One guy got in for $50,000. He made $60,000 and he said that he was going to come up with $200,000 but he wanted to see the money. They sent him his check and that's where they became hogs because they got butchered because he never came back with his $200,000 and when I got out and the rest, you know, they called—now I found out many of these friends of mine did and they went on my okay and I kind of feel responsible for that and that's why and you know me. I'll loyal to my friends. I will go all out for them and what happened when my friends got in trouble I was the first guy they called.

They did not call Power Securities or the broker because they went with Mike Tony. They didn't go with Power Securities or the broker and the first thing that I did when I felt a scam I called Jenny Olds who is assistant to you and I had asked her to investigate and I did whatever I could with you and with the Governor and to find out what can these people do to get their money back and I had about 30 people.

I had some coaches in there, and I don't want to mention names. I don't want to embarrass anyone, and I did have some coaches in there. One coach got his money back. Another coach did not and he was—some people did get their money back and I had gone to this man and asked him to get some of these people their money. Most of the people that had big money. Some people got their money back. Some people didn't.

I have friends from Ohio that invested and they lost money. That's federal I think. I had people from Oregon. I had people from California. I had people from Texas. I had people from New York. And of course people in Las Vegas and the people in Las Vegas I live with and I truly in all sincerity the people that I talked to I know the broker. He was my friend. He does not—he really didn't understand the stock. He was doing a job. He didn't know anything about it. He was very naive in this business. I cannot blame him.

He was only going by what he was told and by the way he was trained the general manager and I truly believe he had good intentions. I really do and the reason I felt he did because he really felt that he was doing a service for his customers. I think the scam came from off the top. I think the guy that ran the place got himself involved with certain stock manipulators or experts and this brought him down to his downfall.

There was one particular stock in which the Star Publication I think it was out of New York the people that had the Star were stock experts and what they did when I checked the thing out. To

this day there are stocks that my friends have that are so-called selling in the penny stock market but they're like they bought them for 15, 20 cents right now they're worth a penny, a half a cent so whether it's legitimate that these stocks are even though they're trading at a half a cent.

For an example I have a friend of mine that invested $2500. If he cashed out today I don't think he would get $20. That's what it would be worth and that was like last week because I'm still trying to get these people their money back. And what I tried to do for them is if I had the money to give them, I would give it to them because I okayed it and I just don't have that kind of money. As you know, I'm a working man and I just don't have that kind of money to pay back. I would estimate about $150,000 of the people that I couldn't get their money back for.

Senator BRYAN. Mike, we appreciate your comments—we'll have some questions in just a moment. We really have a unique opportunity in Mr. Dzarnoski here who, before he saw the light and in effect recognized what was occurring and changed and left this type enterprise, saw how it's really operated on the inside. We'd be most interested, Mr. Dzarnoski, if you'd give us kind of an inside scoop of what, how the operation works, what kind of training, if any, exists, what kinds of information the brokers are given and what you know about the companies with which you're purportedly trading in the stock. We appreciate your being here today.

STATEMENT OF MARK DZARNOSKI

Mr. DZARNOSKI. Thank you, Senator. Members of the committee, good afternoon. My name is Mark Dzarnoski, and I'm currently an attorney with the law firm of Gentile, Porter and Kelesis. As the Senator mentioned, prior to that time I was with the Nevada Securities Commission as a securities examiner and prior to that I did work for approximately four years locally for various penny stock brokerage firms including the now infamous Stoneridge Securities which was closed in large part due to the efforts of the Nevada Securities Division during my tenure there with the State, and what I hope to offer you today is an unique perspective of one who has sort of slept with the devil, walked with the saints and now feels like a hired gun for both.

I would like to preface my remarks by stating several assumptions upon which they are based. One is that all stocks rise and fall directly as a result of supply and demand. In this regard too the chief difference between pink sheeted, penny stocks and all other stocks is that all other stocks is supply and demand as dictated by economic performance of the companies themselves and/or the economy in general while this is clearly not the case for pink sheet penny stocks.

Three, pink sheet penny stocks are directly susceptible to manipulation because their small capitalization makes it possible for someone to control the supply and to artificially create the demand through sophisticated sales techniques including extensive telemarketing and, finally, four, and I'm glad I've heard other speakers say this today, even though even only one in 20 of the companies that do trade in the pink sheets ever develop into viable companies the

OTC pink sheet market is a legitimate capital market and it is necessary for business growth and job creation.

I would suggest to this Committee that the supply side as long as there is a stock market there will be charletons and thieves who will attempt to corner the supply of corporate stocks. Indeed before the Securities Act of 1933 was enacted this was an accepted trade in practice and in fact vast fortunes of family wealth that still exist today were created.

The song of that siren of easy riches will always be heard by some. I do believe that the greater question is what motivates the individual brokers who create the demand through telemarketing or otherwise and I think you've got to accept that the majority of the brokers who are selling these stocks and even the ones that are being manipulated do not know that they are participating in a fraud. They simply do not know that the supply of the stock is tightly controlled by a select few individuals.

These are not the same animals as the people who are working in the boiler rooms. If you heard the testimony of the gentleman from Consumer Affairs when he gave you the definition of a boiler room. No penny stock firm in this country would fall under the definition of a boiler room. And I think that if you're going to attack telemarketing, you're going to have to in some sense separate penny stock telemarketing fraud from telemarketing fraud in general out of boiler rooms.

I think you would find if you worked in the industry that the majority of brokers would rather quit their jobs than intentionally put individuals like these individuals into a scam. Yet the fact remains that you can walk into any sophisticated brokerage house that does employ a telemarketing technique and you will find 9 out of 10 of the brokers working there are all pitching the same small groups of stock and chances are one of them is being manipulated.

Why and how do the brokers end up being attracted to these particular stocks? I don't believe that the culprit is the sales approach that's utilized. You've heard these two gentlemen testify already this afternoon. They were not contacted through telephone. The people who were victimized were his referrals from one of the gentlemen. The other gentleman, Mr. Yerushalmi, was contacted in person. Now the culprit is not the approach itself. It is not the medium that is being used, but it's the message that's being delivered and I think the problem with the SEC regulation on cold calling is twofold.

One, as you will see from the rest of my presentation I believe that it may in fact actually exacerbate the problem of penny stock fraud, and second, it is a broad brush approach that does not distinguish between legitimate penny stocks and those penny stocks that are being manipulated. It is my contention that the single-most significant reason that you will find honest people selling dishonest investments is the Commission's structure under which they are operating.

Brokerage firms in their market-making roles establish what is called a bid and an asked price on these over-the-counter stocks. The bid price is what a customer who owns the stock would get if he were to sell it. The asked price is the price that he must pay if

he is to buy it. The brokerage house in turn dictates what portion of that difference will go to the brokers in commissions.

I give you a hypothetical example. You have broker "A" and broker "B" selling stock "A" and stock "B". Both stocks are quoted at 5 cents bid, 10 cents asked. In both cases if you were to be a purchaser, you would pay ten and a half cents for that stock. The brokerage firm in stock "A" tells the broker that if he is to sell that stock to a client, the broker will purchase the stock for 10 cents and may mark it up a half a cent in commission, the legally allowable 5 percent commission structure.

Stock "B" the brokers are told can be purchased by the broker at a nickel a share and marked up 5 and a half cents a share in commissions. The client still pays 10 and a half cents per share for either stock but I ask you, members of the committee, if you were a broker and you were selling stocks in the marketplace, which stock would you chose to sell? Would you sell the stock where you're making 5 percent commission or 55 percent commission?

Broker "A" who works one full month and raises $100,000 worth of investment money purchases stock "A", earns $5,000 in commissions. Broker "B" raises the same $100,000 from his clients, invests their funds in stock "B". He earns $55,000 in that month in commissions. The ultimate indignity in this to broker "A" who may have worked just as hard and may have done his own research on his stock is that after the month is over broker "B" stocks is likely the one to have risen in the marketplace because stock manipulations do work in their initial stages.

Broker "B"s stock is probably 1 out of the 19 out of the 20 in the penny stock market that is going to drop and therefore he is going to have unhappy clients. So after the month is over you've got broker "B" who is happy with happy clients and broker "A" who is unhappy with unhappy clients. It doesn't take long for broker "A" to either wash out of business and determine he's not fit to be a penny stockbroker or to learn what stocks to sell.

As to the extent that the recent SEC regulations on cold calling will undoubtedly cut down on a number of sales that a broker will make, it will also increase the importance of maximizing the commission on each sale; therefore, these brokers are only going to have this problem exacerbated and it's my opinion that if you are going to be regulating further in the penny stock industry that you should give some serious consideration to how you can change the disproportionate commission structure that is built into the purchase and sales of securities because that, gentlemen, is what motivates those people to become a highly organized sales force that is pitching a small select few stocks one of which is being manipulated by brokerage firm principals and/or corporate insiders. Thank you for the opportunity today.

Senator BRYAN. Thank you very much, Mr. Dzarnoski, and we'll now hear from Mr. Don Garvin who also escaped the hand of fate. Mr. Garvin, nice to have you with us.

STATEMENT OF DON GARVIN

Mr. GARVIN. Was I ever lucky.

Senator BRYAN. You were indeed and we appreciate your sharing your time with us today and telling us a little bit about your experience.

Mr. GARVIN. I got contacted by Mr. McBride by phone and he called me, oh, every day for two or three days and finally I consented to buy $2200 worth. All right. He'd have somebody up there right away to pick it up. In the meantime my wife, she had something, somewhere to go, took me with her.

So when I got back there was a note on the screen door, not at home. That's how I got out of it but I did get two or three letters from Denver one saying I owed the $3,020 and the next time and I guess the third letter was that it was closed so that's how I got out of it through my wife.

Senator BRYAN. Maybe we'll just start with you and ask you a few questions if we might, Mr. Garvin. May I take it from your testimony that this Mr. McBride who called you, you did not have a personal relationship with him?

Mr. GARVIN. No, I didn't know him.

Senator BRYAN. You did not know him. Wasn't a friend or acquaintance. This was, as we say, a call out of the blue.

Mr. GARVIN. Huh?

Senator BRYAN. I mean you got a phone call and this fellow on the other end of the phone said, "I'm Mr. McBride. I understand you're Mr. Garvin," and began like that. You did not know him at all.

Mr. GARVIN. No, I didn't know him. I didn't know him.

Senator BRYAN. And how many times did he call you before you finally decided to buy part of the program that he was selling?

Mr. GARVIN. Oh, about three times. He was a super salesman I'll tell you.

Senator BRYAN. Did he ask you anything about your financial circumstances?

Mr. GARVIN. No.

Senator BRYAN. Did he ask how old you were, or what your investment goals were or how much money you had to invest and how much savings you had?

Mr. GARVIN. No, no. He didn't do that at all. He just told me what a good company he was with.

Mrs. GARVIN. Didn't you tell him you sold some land? Sure you did.

Senator BRYAN. I take it this is Mrs. Garvin saving you one more time. She is a good woman. You better keep her happy.

Mr. GARVIN. I'm going to.

Senator BRYAN. Good.

Mrs. GARVIN. He told him that he had sold some property and that he had some money.

Senator BRYAN. I see.

Mrs. GARVIN. They asked him if he wouldn't like to make a lot of money and he said yes.

Senator BRYAN. Mrs. Garvin, did you have the impression, you and Mr. Garvin, that somebody had given Mr. McBride your name or somebody had reported that you had just sold some property or was this literally a case of your name just taken out of the book, or could you tell?

Mrs. GARVIN. Well, I think that lists go around probably. I don't know how it goes but people certainly get your name if you have some loose money. I don't know how it goes but they do.

Senator BRYAN. There's a network, isn't there?

Mrs. GARVIN. It seems like it.

Senator BRYAN. Tell us what caused you to reconsider. You decided that you were going to buy this, that you were going to make some pretty good money, Mrs. Garvin had you take her on a little errand. You come back. There's a note on the door. You get some follow-up letters that you owe the company a certain amount of money but something must have intervened that alerted you this may not be the good deal that you thought it was. Could you share with us what your reasoning was or what occurred.

Mrs. GARVIN. My husband didn't tell me about this sale for a few days.

Senator BRYAN. There's a lesson for all of us husbands on that, isn't there? That may be the subject of another hearing but——

Mrs. GARVIN. So when I—when he called again and I heard about it, I had just read a piece in the "Review-Journal" about the trouble that Power Securities was having in Florida so I talked to my husband later and he called the company and canceled the order.

Well, the next day Mr. McBride called again and he really put on the salesmanship then and told my husband that he had to send in the money, he'd already sent in the money and he'd be counted as responsible for it and that we'd be taking the money out of his little boy's—food out of his mouth and all kinds of dire things so my husband said, "Oh, all right. I'll—I don't want to do that. I'll pay it then."

So that's when I took him out for the afternoon. So then I wrote a letter to the company and cancelled the order and had a copy of it.

Senator BRYAN. We have representatives of the "Review-Journal" here with us this afternoon. I can just see the story heading this thing. "Saved by the 'Review-Journal' and Mrs. Garvin." We thank you very, very much. Please just sit there and relax in case we have some other questions, but you've been most helpful and I'm sure many others were approached but did not have the foresight that Mrs. Garvin provided.

Mr. GARVIN. I didn't know she called.

Senator BRYAN. If we can return now to Mordechai. Let's talk about your situation a little bit. Mr. Dzarnoski made an interesting observation and if I understand your factual situation and the comment that he made this new rule that's been promulgated by the Securities and Exchange Commission, according to Mr. Goldstein, is directed to the cold call—that is the situation the Garvins had. The rule really wouldn't have been applicable as it relates to your situation because you were not solicited by phone, as I understand it.

Mr. YERUSHALMI. No. He brought in a friend, somebody that I knew for many years to introduce him to me so this way it would be easier for him to get his foot in the door.

Senator BRYAN. Now I have known you for a good many years and know that you are not only a sophisticated but a very success-

ful business person in this community. Looking back if you could reconstruct this whole thing in your own mind, what would you recommend to somebody like myself that may be able to influence legislation or policy, what should we do in your opinion to protect people like yourself from these kinds of operations? What would have been a sufficient trigger or a warning to you that this doesn't look right. I think I better——

Mr. YERUSHALMI. In my situation it was a very different, little different than it was if it was somebody off the streets, somebody I didn't know I would definitely hesitate and would check into it much more. As far as the general public I've seen a lot of commercials on TV as far as mail fraud and how to do about somebody's suspecting anything that has to do with mail fraud. I think that if certain type messages would come across the public that they would have a phone number to call and immediately to be able to get an answer if they have a small suspicion. That will be a tremendous help I think. Unfortunately in a way I can afford the loss. OK. Some people cannot afford the loss and something like that can be devastating for them.

Senator BRYAN. Are you suggesting something like a public service announcement regarding community events and activities that are oftentimes featured on television.

Mr. YERUSHALMI. On television, right.

Senator BRYAN. Are you talking about some type of a public service announcement that perhaps the media, the broadcast media might be willing to develop with the Secretary of State's office here in Nevada, or the Securities Division, that says "If you're called, if you're approached, you know, please"——

Mr. YERUSHALMI. Call that number.

Senator BRYAN. Check and see if—something like that might have been helpful.

Mr. YERUSHALMI. Right, definitely I think it would.

Senator BRYAN. In your situation. All right. I know that Frankie Sue Del Papa may want to pursue that, Mordechai, and talk with the broadcast media. That might be one way of better informing the public.

Mr. YERUSHALMI. Right. I definitely think so.

Senator BRYAN. Mike, it sounds like your situation is a little bit like Mordechai's in that you placed your trust——

Mr. YERUSHALMI. Correct, the person because I know the person that introduced him to me for over ten years.

Senator BRYAN. I believe Mike is saying the same thing essentially. If you've got somebody that you know that you think is straight and that you can rely upon his or her word you're kind of willing to go along with his or her recommendation as to what you ought to do.

Mr. YERUSHALMI. I still believe that the person who introduced him to me had nothing to do with it. He did not even know what was going on.

Senator BRYAN. Mike, I believe you might want to respond to that. I think you made the comment you don't believe that your broker was really in on the scam. You don't think he really knew what was——

Mr. TONY. He trusted me with his son to send him to college and picking the school. His son was a great football player here and I made the decision on the school for his son feeling that if this boy was going to go to a certain school he was going to be there for four years, graduate with a degree, football was secondary. That's how close I was with him and I truly feel that—I mean I know. I know the man for 20 years. I knew him when I first came here that he just got a job. He was looking for work. He became a stockbroker.

He thought this was a legitimate job and a stockbroker's a good profession and when he became a stockbroker I told him, "I never heard of that stock company and I play stock." I said, "Do you know what you're doing?" And so he says, "Yes." So I gave him a play. He was a friend of mine and I made money in the stock market. I was at one time strictly a blue chip player and then when the gaming stocks came in I bought Caesar's World. I bought Golden Nugget. I bought MGM. I made money on it so I played, and the more money you make, I guess the greedier you get.

When you play stock it's like gambling. There's no difference in playing the crap table than playing the stock market. It's only a little sophisticated one and in this situation and you asked the question, Senator, and I feel this way.

I had never heard of penny stocks. I wasn't involved in that kind of stock. Any stock that's sold in this state should be sold through a major stockbrokerage, a Prudential-Bache, a Merrill Lynch, Dean-Witter. Any other stocks comparable to that type agency. Any other stock market or any other stock shouldn't be sold at all in this state.

I think the State of Kentucky has a rule—I don't know exactly what the particulars are but there are penny stocks that can't get into that state and they have certain kind of restrictions there and I think that if you guys can look into that.

You know, we come from a gaming city and a lot of people around this country feel that the thieves are here. We want to keep the thieves out of this town because this town is a legitimate town. This town you can get a fair shake. You never ever very seldom ever catch thieves into the hotels taking people's money. You have people taking the money out of the hotel and they're caught cheating because anyone caught cheating that works in a hotel can never get a job again and so we want to keep the thieves out of this state and especially Las Vegas who has a reputation of being a gaming city but we also have schools and we also have churches here and we also have children here.

I live here. I've been here for 20 years. I have my children brought up in this town. I love this town. This town's been great to me and I'll do anything I can to keep the thieves out of it.

Senator BRYAN. I appreciate your testimony. Mr. Dzarnoski, let me ask you to pick up on a couple of things. Both Mr. Tony and Mr. Yerushalmi have indicated that they relied basically upon a person who they believed to be innocent of any scam whom they had reason to trust. In the way these operations are developed, you've been on the inside—is it possible in your judgment that a person who holds himself or herself out as a broker may not be a part of any of the scam operation and is acting in good faith in rec-

ommending to friends and neighbors and others a particular stock as being a good investment?

Mr. DZARNOSKI. That's absolutely the case, Senator. Again, as I refer back somewhat to my remarks, the majority of the brokers, and I would go so far as to indicate that 95 percent of the brokers, who are selling the stocks that are being manipulated do not know that they are partaking in a fraudulent activity.

Senator BRYAN. How do we address that then? Let's assume that your premise is correct and you are in effect authenticating the testimony of the two witnesses previous to you. How do we address that? Is it appropriate to require more training, more instruction on the part of the broker to make sure that if he or she is a legitimate broker that they are aware of the kinds of activity which brings many of the folks here today, not just those who testified, who have suffered from that occurs in these penny stock options.

Mr. DZARNOSKI. I think education of the brokers is one alternative although the examination that is required a Series 7 examination of brokers is fairly extensive so there is a basis of training that every broker or basis of knowledge that every broker gets before he is licensed. I think that one thing that I would get back to again, and I don't mean to harp on it, is the amount of commissions and the structure that these brokers are operating under.

I would be willing to wager that the stocks that Mr. Yerushalmi was involved in and perhaps Mr. Tony the brokers made anywhere from 30 to 50 percent commissions on inside mark-ups and they did not know that the stock was being manipulated but due to the nature of the commission structures they are almost economically required to sell those particular stocks and they may even have purchased it on their own because, again, in the initial stages a stock does rise in manipulation and the brokers will have happy clients at one stage. Mr. Tony had profits. Some of his referrals made profits in the initial stages and Mr. Yerushalmi's. They never see it but that's how the manipulation works.

Senator BRYAN. So you recommend a statute or a regulation putting a limit on the amount of commission that's authorized?

Mr. DZARNOSKI. Ostensibly there is a 5 percent rule but due to the fact of how spreads are manipulated in brokerage houses that 5 percent rule really doesn't have any impact on the day-to-day operation selling of pink sheet stock and I also suggest that perhaps disclosure enough of what the commissions are and the takes of the brokerage house would significantly deter a broker from having to or from deciding to sell stock.

I know from personal experience and witnessing brokers that when they sell a stock that has a 30 percent mark-up where they're getting maybe $500 out of the client's thousand dollar investment that the first question they ask at their trading desk will this be disclosed on the ticket to the customer? Will he see how much I'm making? If the customer sees how much he's making, I don't think Mr. Yerushalmi would buy something from his mother where he knew that 50 percent was the profit. I wouldn't buy something from my mother knowing that and I think the same goes for a broker.

Senator BRYAN. Regulation for disclosure, regulation to tighten up the 5 percent rule that you're talking about that apparently in

these penny stock situations either constitutes a loop hole or the price spread is manipulated in such a fashion that the 5 percent does not in fact mean 5 percent, if I understand your testimony.

Mr. DZARNOSKI. That's correct, Senator.

Senator BRYAN. You said that you thought that maybe the rule that Mr. Goldstein testified to, that cold call rule, for lack of a better description, that you thought that might be counterproductive and we have one gentleman, Mr. Garvin here, who would seem to fit within the category of the rule that would be protected. Under those circumstances maybe you can respond. It wouldn't have helped our two gentlemen to your left but would it have protected Mr. Garvin?

Mr. DZARNOSKI. It perhaps could have protected Mr. Garvin but the residual feature of that let's say the broker in the case of Mr. Garvin did get his money I'm glad that he certainly didn't, but to the extent that that cold calling rule would stop Mr. Garvin from making a purchase, that's one less purchase that that broker or one less sale that that broker is making for that month.

The brokers are working a commission. They have to feed their families and to the extent that the absolute number of sales will undoubtedly drop with the cold calling rule, that becomes even more important for that broker to maximize the commission that he will make on the sales that he does do and therefore they would further be attracted towards the huge mark-ups in the stocks that are being manipulated.

Senator BRYAN. What about Mr. Tony's suggestion? He mentioned Prudential-Bache, a very fine, very legitimate brokerage house. What about his suggestion that if this penny stock is continued to be marketed, that it has to be marketed only by houses that have that kind of stature or standing in the marketplace? How would you respond to that suggestion, Mr. Dzarnoski?

Mr. DZARNOSKI. I respond to that by saying if every state in the union did that, there would be no more penny stock market. If the goal is to eliminate the penny stock market because you just felt it was overwrought with fraud, then that certainly would do it because those firms will not market those securities. If you view the penny stock market as a legitimate capital market, then there has to be brokerage houses that are allowed to sell that that are not of the caliber of a Merrill Lynch or a Prudential-Bache.

Senator BRYAN. You're saying that those brokerages just do not handle that kind of stock—that's they're own internal policy, I take it.

Mr. DZARNOSKI. That's correct, sir. For those brokerage houses do not touch penny stocks.

Senator BRYAN. Your argument that may have been a bit overlooked here is that you felt in your testimony and indeed the testimony that was presented by the Secretary of State as to the same effect that there is a legitimate capital market for penny stocks in terms of supporting and providing entrepreneurial capital.

Mr. DZARNOSKI. Absolutely, Senator. There must be 20,000 stocks traded on the pink sheets of the over-the-counter market and without the ability to raise funds in that market, how many jobs are attached to those 20,000 companies is anyone's guess.

Senator BRYAN. Could you share with us, admittedly it's not a precise calculation that we're asking you to make, but of the 20,000 stocks how many would fall within the category of what we're talking about here? Outfits that are manipulated, that are used to victimize and defraud people. Are we talking about a 1 percent problem, a 5 percent problem, a 10 percent problem, and admittedly it might vary from time to time. But give us your own assessment based upon your inside experience in terms of the dimension of the problem, not in terms of dollar loss. We've had that and it's enormous, as you know, but give us your view in terms of the number of companies that are penny stock companies so to speak that in effect constitute the problem that we're here addressing this afternoon.

Mr. DZARNOSKI. I wouldn't even be able to touch upon an answer to that, Senator, for the basic reason that maybe 19 out of 20 of the companies that trade there are so undercapitalized that they're going to fail regardless of whether they're manipulated so it's difficult to tell just from seeing a stock drop whether or not it was a stock that was manipulated and then once the manipulation was done cut loose or whether it was a legitimate company that just failed on its own account.

Senator BRYAN. Anything else that you might want to share with us as we head back after the congressional recess to put together some type of legislative response to this problem?

Mr. DZARNOSKI. No, sir, but I do thank you for the opportunity.

Senator BRYAN. We thank you. We thank all of the witnesses for being here today to share with us. I think it is clear that the dimension of the problem, its magnitude, its potential for victimizing innocent individuals not only in our own community but across the country is widespread. I think it's equally clear that the response must be a combination, as we saw here today, a Federal-State response.

We had two examples with the Consumers Division here in the State of Nevada and their telemarketing procedures that have been adopted in the last legislative session, and the powers that have been adopted for the Securities Division of the Secretary of State's office since 1987. But I think it's equally clear that the problem cannot be solved on a strictly intrastate basis, that the very nature of telemarketing operations is migratory. It is here today and gone tomorrow.

We may do a fine job in one State and indeed I think there's testimony in this record that would indicate the number of the so-called boiler room operations in Nevada has decreased markedly in the last two years from something like 400 if I recall the testimony down to 60. So considerable progress is being made here in Nevada to the credit of the Attorney General's office, the Consumer Affairs Division and other law enforcement agencies. But we're going to have to build upon the State experience and develop something that will add to that enforcement mechanism and work at the Federal level to address the interstate aspects of that and I certainly appreciate very much the testimony that's been offered here.

We'll return with those thoughts and for those of you who were not able to testify today but would like to share any experiences or thoughts with us, we're going to keep this record open on this hear-

ing for another two weeks so please drop us a note and let us know any thoughts that you might have. Once again not only do we want to thank the panels for their attendance and the staff for arranging the hearings and for their attendance and participation today but also those of you in the audience that came to be better informed. This subcommittee stands in recess.

[Whereupon at 4:30 p.m., the meeting was adjourned.]

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